Chapter 9

Financial Management

Chapter 9 Financial Management

Short Answer Questions

Q1) When is financial leverage considered favorable?

Ans) Financial leverage is considered favourable when return on investment is higher than the cost of debt.

Q2) why does financial risk arise?

Ans) Interest on borrowed fund have to be paid regardless of whether or not you firm has made a profit. Moreover borrowed fund have to be repaid after a fixed time and it carries a charge on assets. This gives rise to financial risk.

Q3) How does production cycle effect working capital?

Ans) working capital requirement is higher with longer production cycle.

Q4) Enumerate two objectives of financial management?

Ans) (a)To ensure availability of required funds.
(b) to see that the firm does not raise resources unnecessarily.

Q5) What is the primary objectives of financial management?

Ans) Wealth Maximisation.

Q6) The board of Directors has asked you to design the capital structure of the company. Explain any sin factors that you would consider while doing so. 6

Ans) For design the capital structure of the company six factors are as following:-
1) Cash Flow Position.
2) Interest coverage ration(ICR)
3) Debt Service coverage ratio(DSCR)
4) Return on investment (ROI)
5) Cost of debt
6) Tax rate.

Q7) Every manager has to take three major decisions while performing the finance function. Explain them.

Ans) A manager take three following major decisions:-
1) financing Decision.
2) Investment Decision.
3) Dividend Decision.

Q8) What do you call the capital needed for day to day operations? Explain any 5 factors affecting such capital needs.

Ans) Capital needed for day to day operations is called working capital.{explain any 5 factors affecting such capital needs].
1) Nature of business
2) Scale of operations
3) Seasonal Factors
4) Production cycle
5) Credit allowed

Q9) The directors of a company have decided to expand their business activities by increasing the stock of raw materials and finished goods at an estimated cost of Rs. 50 lakhs, Describe the various ways open to the company to raise necessary finance for the purpose.

Ans) the company can raise necessary finance for the purpose of expansion through the following function.
(a) Issue of shares
(b) Issue of debentures
(c) Loans from banks and financial institutions.
(d) Retained earnings.

Q10) A capital budgeting decisions is capable of changing the financial fortune of a business. Do you agree? Why or why not?

Ans) hint Yes, I agree to this statement because of the following importance of capitals budgeting decisions.
(a) long term growth and effects.

(b) Large amt of funds involved
(c) Risk involved
(d) Irreversible decisions.

Q11) Are the share holders of a company likely to gain with a debt component in the capital employed ? Explain with the help of an example?

Ans) The shareholders of a company are very likely to gain with debt component in the capital employed by way of trading
On equity as it increases the earning per share(EPS) of the share holders

Q12) state whether the working capital requirements of business manufacturing the following items are big or small. Justify your statement.
(a) Coolers (c) Sugar (b)bread (d) Locomotives (e) Furniture manufacturing against orders.

Ans) Requirements of working capital for the mentioned business will be:
(a) Bread Requirements of working capital will be less because it has quick cash turnover.
(b) Sugar;- working capital required for manufacturers will be more as ration of raw material cost to total cost is more.
(c) Coolers:- working capital required for manufacturers of cooler will be more because it is a seasonal product.
(d) Furniture:- Requirements of working capital for a manufacturer of furniture manufactured against specific order is less as it doesn’t requires large stock.
(e) Motor car;- Requirements of working capital for a manufacturer of locomotives will be more because gestation period is more.

Q13) What do you mean by floatation cost?

Ans) Cost uncured for raising funds.

Q14) Name any 2 sources of long term fund?

Ans) (a) Debt.
(b) Equity

Q15) What is Business Finance?

Ans) Money required for carrying out business activities is called business finance.

Q16) " A decision to acquire a new and modern plant to upgrade an old one". Identify the aspect of financial decision.

Ans) Investment decision (Capital Budgeting).

Exercises

Very Short Answer Questions

Q1. What is meant by capital structure?

Capital structure is the combination of debt and equity, which is used by a company to finance its requirements for funds. Debt can be obtained in the form of loans, while equity is generated through retained earnings or common stock.

Q2. Discuss the two objectives of Financial Planning.

Financial planning is the process of framing financial policies, procedures, programs and budgets that are necessary for the financial activities of the enterprise.

Objectives of financial planning are:

1. To ensure proper utilisation of funds available for the organisational activities.

2. To determine the capital structure, which is the composition of debt and equity that is necessary for a business.

Q3. Name the concept of financial management, which increases the return to equity shareholders due to the presence of fixed financial charges.

Trading on equity concept increases returns to equity shareholders due to the presence of fixed financial charges.

Q4. Amrit is running a 'transport service' and earning good returns by providing this service to industries. Giving reason, state whether the working capital requirement of the firm will be 'less' or 'more'.

The type of business conducted by Amrit is transport service which will be operating on a large scale. Hence, there is a need for more amount of working capital.

Q5. Ramnath is into the business of assembling and selling televisions. Recently he has adopted a new policy of purchasing the components on three months' credit and selling the complete product in cash. Will it affect the requirement for working capital? Give reasons in support of your answer

As Ramnath has adopted the policy of purchasing components on credit for 3 months and selling the product in cash, the working capital requirement is reduced.

Short Answer Questions

Q1. What is financial risk? Why does it arise?

Financial risk is said to be the situation when a company is unable to meet its set of fixed expenses such as interest payment, loan repayment and preference dividend pay-out. It is a situation where a company is unable to meet its financial obligations. Financial risk arises due to the high level of debt in the capital structure. A high level of debt leads to a high amount of interest which increases the chances of defaulting on payment.

Q2. Define a 'current asset'. Give four examples of such assets.

The current assets of a firm are those assets that have the potential to be converted into cash or cash equivalents within the current accounting period. Current assets provide liquidity to the company. Examples of current assets are cash, short-term investment, marketable securities and debtors.

Q3. What are the main objectives of financial management? Briefly explain.

The main objective of financial management is the maximisation of shareholders' wealth. Therefore, financial management is all about making those decisions that will bring gains for the shareholders. Gains can be said to be achieved when the market value of shares rises. Once the primary objective of wealth maximisation is achieved, the other objectives, such as maintaining liquidity and proper utilisation of funds, are fulfilled along with it.

Q4. Financial management is based on three broad financial decisions. What are these?

Financial management is the technique of proper allocation, acquisition and use of funds by the company. The three broad financial decisions on which financial management is based are investment decisions, financial decisions and dividend decisions.

Q5. Sunrises Ltd., dealing in readymade garments, is planning to expand its business operations in order to cater to the international market. For this purpose, the company needs an additional 80,00,000 to replace machines with modern machinery of higher production capacity. The company wishes to raise the required funds by issuing debentures. The debt can be issued at an estimated cost of 10%. The EBIT for the previous year of the company was 8,00,000, and the total capital investment was 1,00,00,000. Suggest whether the issue of debenture would be considered a rational decision by the company. Give reasons to justify your answer. (Ans. No, the Cost of Debt (10%) is more than ROI which is 8%).

A company is able to issue debentures for fundraising when the debt cost is less than the cost of capital.

In this question, the cost of capital of Sunrises Limited is 10% which is 8,00,000, as the total capital is 80,00,000.

Now, the return on investment is calculated as

ROI = Return / Investment

= 8,00,000/1,00,00,000

= 8 %

Assuming that the company will be operating with the same efficiency, the additional investment of 80,00,000 will have an ROI of 8%, which will amount to 6,40,000.

The cost of debt will be 8,00,000, which is more than the ROI of 6,40,000. Therefore, it is advisable for a company not to issue a debenture when the cost of debt is higher than the cost of capital.

Q6. How does working capital affect both the liquidity as well as the profitability of a business?

Working capital in a business is the surplus that is determined by subtracting current liabilities from the current assets of the organisation. By increasing the working capital, the liquidity of an organisation increases. But more current assets present in business results in a fall in profitability of the organisation, as current assets offer low returns, which cause a decline in the profit of a business.

Q7. Aval Ltd. is engaged in the business of export of canvas goods and bags. In the past, the performance of the company had been up to expectations. In line with the latest demand in the market, the company decided to venture into leather goods, for which it required specialised machinery. For this, the Finance Manager Prabhu prepared a financial blueprint of the organisation's future operations to estimate the number of funds required and the timings with the objective of ensuring that enough funds are available at the right time. He also collected relevant data about the profit estimates for the coming years. By doing this, he wanted to be sure about the availability of funds from the internal sources of the business. For the remaining funds, he is trying to find out alternative sources from outside.

a. Identify the financial concept discussed in the above paragraph. Also, state the objectives to be achieved by the use of the financial concept so identified. (Financial Planning)

b. 'There is no restriction on payment of dividends by a company.' Comment. (Legal & Contractual Constraints)

a. The financial concept discussed here is capital budgeting; it is the decision regarding capital investment which will have an impact on the profitability of the company in the long term.

The company wants to invest in new machinery, which needs investment, this will have a direct impact on the operations, which will result in affecting the profitability of the organisation.

The following objectives can be achieved:

1. Cash flow: Investment will bring new machinery, which will increase organisations' profitability.

2. When a company wants to raise funds from both inside and outside the organisation, it will be helpful to analyse that return generated from such investment will be more than the cost of capital.

3. Investment used: The company is planning to raise funds from both inside and outside. It is important to know that funds from internal and external sources will have different rates of interest.

b. Companies pay dividends to shareholders, which are part of the company earnings. Paying of dividends is based on the following factors:

1. Legal Constraint: Legal constraints are such constraints that are mentioned in the company laws which impact paying out dividends on certain occasions. It should be followed properly.

2. Contractual Constraints: Paying out of dividends reduces cash in the company. Money that is raised as a loan will put certain restrictions on the company for paying dividends, such constraints are called contractual constraints.

Chapter 9 Financial Management

Long Answer Questions

Q1. What is working capital? How is it calculated? Discuss five important determinants of working capital requirement.

Working capital in a business is the surplus that is determined by subtracting current liabilities from the current assets of the organisation. Current assets are those assets that can be converted into cash or cash equivalent within the current accounting period. Two broad categories of working capital can be classified:

1. Gross Working Capital

2. Net Working Capital

Gross Working Capital is referred to as the current assets that are present in the balance sheet of a company.

Net Working Capital is the difference between current assets and current liabilities present in the balance sheet of an organisation. Net working capital is considered to be more relevant for capital financing and management.

Working capital is calculated as

Working Capital = Current Assets – Current Liabilities

The following are the determinants of the working capital requirement:

1. Business Type: The nature of the business of a firm determines its working capital requirement. The size and type of operations of an organisation will affect the extent of working capital required. For example, firms that offer services will have low working capital requirements, whereas a manufacturing plant will have a large working capital requirement. The operating cycle of such a firm is more.

2. Scale of operations: The extent of the scale of operations is a determining factor for working capital. A firm having a large scale of operation will see an increase in working capital requirement as firms have a high requirement of maintaining inventory. Similarly, a firm having a small scale of operations will have a low working capital requirement.

3. Fluctuations of Business Cycle: The working capital will also vary with the different phases in which a business is running. During high demand in the market, there will be a high requirement for production; so, working capital will be more, whereas in terms of low demand.

4. Production Cycle: Every industry will have a different production cycle depending on the type of industry. A firm having a longer production cycle will have a higher requirement of working capital, and firms having a short production cycle will have a low working capital requirement.

5. Growth Prospects: Companies that have higher growth prospects and are looking for expansion have a higher working capital requirement.

Q2. “Capital structure decision is essentially optimisation of risk-return relationship.” Comment.

Capital structure is the combination of debt and equity, which is used by a company to finance its requirements for funds. Debt can be obtained in the form of loans, while equity is generated through retained earnings or common stock. Borrowed funds can be in the form of loans, debentures, bank loans, etc. While in the case of an owner’s fund, it can be in the form of preference share capital, reserves, retained earnings, equity share capital, etc.

Debt and equity both have their risk and profitability. Debt is a relatively cheap source while the greater risk is there, and equity is comparatively expensive but is of lower risk for the firm. Fundraising through debt is cheaper, while same with equity is expensive. Debt, though cheaper, has more risks, as it has an obligation towards lenders. For equity, there is no such compulsion to pay dividends.

Also, the return offered by the sources leads to an increase in value per share. Debt gives higher returns per share but increases the risk comparatively many times.

Therefore, capital structure decisions should be taken into consideration with return and the amount of risk involved.

Q3. "A capital budgeting decision is capable of changing the financial fortunes of a business." Do you agree? Why or why not?

Capital budgeting decision needs to be taken very carefully, as the fortunes of a business can be changed with such a decision. The decision of capital budgeting is the allocation of fixed capital to different projects. Capital budgeting involves purchasing new assets, or it can be regarding the replacement or modernisation of the assets. All these decisions have a long-term impact on the business and can affect profitability and risk.

The following points highlight the importance of capital budgeting decisions:

1. Investment in long-term assets will yield returns in future and, by doing so, affect the future prospects of a business. Therefore, the kind of decision taken by a company will reflect on its long-term growth.

2. A large amount of funds is required to acquire assets. Therefore, the money that is invested will be blocked for a certain period, which makes it all the more important to plan capital budgeting decisions.

3. Acquiring assets is of high risk because it has a long-term impact on the business. If the return on the asset is less than the investment, the business will be impacted.

4. Decisions, once made, are irreversible as reversing leads to a great amount of loss.

Q4. Explain the factors affecting the dividend decision.

A dividend decision is a decision to share a portion of profit which is to be shared between shareholders and what should be kept as retained earnings. The following factors affect dividend decisions:

1. Businesses are able to pay dividends from current and past earnings. A company which is having higher earnings will be in a better position to pay dividends in comparison to a company having limited earnings.

2. Companies having stable earning are in a good position to provide dividends as compared to companies which are inconsistent in earnings.

3. Companies follow a stable dividend-sharing policy. It will only be changed when there is a rise in earning.

4. Companies that are looking for higher growth may keep a certain portion of earning as dividends while investing the majority in expansion. Therefore, such companies offer lesser dividends.

5. If the company does not have a good cash flow, it will impact the dividends paid out.

6. Company must also check the shareholder preferences while paying dividends, as shareholders may require a certain amount of dividend.

7. Taxation policies play a major role in deciding the dividends. A policy levying high tax on dividend distribution leads to companies offering lower dividends and vice versa.

8. Stock market prices will fluctuate depending on the dividend that is declared. It can rise with a high dividend payout while declining with a low dividend payout.

9. There can be contractual constraints at the time of offering loans that are imposed by the lender in the form of an agreement. Such agreements need to be checked before issuing dividend payouts.

10. Companies having greater access to capital markets can pay a higher dividend and vice versa.

11. Companies have to follow the rules, regulations and restrictions of the Companies Act while declaring dividend pay-out.

Q5. Explain the term ”Trading on Equity”. Why, when and how it can be used by a company?

Trading on equity is a process of using debt in order to produce a gain for the owners. In this process, new debt is taken in order to gain new assets with which they can earn a greater level of interest, which is more than the interest that is paid for the debt. This process is practised as the equity shareholders are only interested in the income that is generated from the business. It is only practised by a company when the rate of return on investment is greater than the rate of interest for the fund that is borrowed. This practice is a form of financial leverage that a company exercises. There is an increase in earnings per share when this process is adopted.

Trading on equity is profitable only when the return on investment is greater than the amount of funds borrowed. It is said that trading on equity shall be avoided if the return on investment is less than the rate of interest from the funds that are borrowed.

Q6. 'S' Limited manufactures steel at its plant in India. It is enjoying a buoyant demand for its products as economic growth is about 7%-8%, and the demand for steel is growing. It is planning to set up a new steel plant to cash on the increased demand. It is estimated that it will require about Rs 5000 crores to set up and about Rs 500 crores of working capital to start the new plant.

Questions

1. Describe the role and objectives of financial management for this company.

2. Explain the importance of having a financial plan for this company. Give an imaginary plan to support your answer.

3. What are the factors which will affect the capital structure of this company?

4. Keeping in mind that it is a highly capital-intensive sector, what factors will affect the fixed and working capital? Give reasons in support of your answer.

1. Role of financial management in this company is as follows:

1. Financial management will help in taking decisions to purchase fixed assets which will increase the composition of fixed assets.

2. The composition of funds that are used by a company refers to the mix of short and long-term funds that are used by the company. Fund composition is determined by the company's decision which is regarding profitability and liquidity. It can be said that if a company is looking to attain higher liquidity, it would be looking to opt for long-term financing and companies looking for short-term liquidity will opt for short-term financing.

3. The proportion of debt and equity that should be used in long-term financing or, in other words, the distribution of funds that are raised with a mix of debt and equity, which is taken by financial management.

4. The amount of current assets that a company holds is dependent on the financial decision of the company. A higher amount will lead to more working capital but a decrease in profits and vice versa.

In this case, the basic objective of financial management will be towards increasing or maximising shareholders' wealth. Decisions that will be beneficial for the shareholders, i.e., help in increasing their market value of shares. This can be achieved if financial management takes a decision that results in an increase in the value of shares where benefits obtained from making this decision exceed the cost of taking the financial decision.

2. These points highlight the importance of financial planning for the company:

i. It enables the company to forecast future requirements.

ii. Financial plan will be helpful in avoiding any kind of shortage that may occur or surplus that can also occur. It ensures that funds are used optimally.

iii. It helps in better coordination between the sales and production teams.

iv. It helps in avoiding any type of waste such as time, money and effort.

v. If the targets and policies are well defined, then financial planning helps in evaluating the performance in a good way.

Proposed Financial Plan

The company can use the 50% through the issue of shares, and the other 50% can be collected using funds that are borrowed from outside in the form of debts.

3. Following factors will affect the capital structure choice:

i. Company should be opting for debt capital in case of strong cash flow is present. Debt requires payment of principal as well as interest that is applicable to the principal.

ii. Debt service coverage ratio determines the obligations towards cash payment of a company as against the cash availability. Having a high DSCR can make the company opt for debt as a source of funds.

iii. Equity cost can be directly related to the financial risk that a company faces. A company having a higher financial risk will see the expectations of shareholders rise, which raises the cost of equity. The rising cost of equity makes it difficult to opt for equity.

iv. Good stock market conditions are very much conducive to for opting equity capital, whereas poor stock market conditions are difficult for opting for equity capital.

v. Higher interest coverage ratio, which is a measure of the times EBIT is able to meet interest rate obligations. A higher interest coverage ratio translates to lower risk for the company, which enables a company to opt for a high portion of debt in the composition of its capital structure.

vi. A high rate of floatation cost leads to a reduction of the component in capital structure. A high floatation cost of equity results in a low capital structure.

vii. Higher rate of interest applicable on debt leads to higher debt cost, which makes it difficult to choose debt as capital structure.

4. Factors affecting fixed capital requirements are as follows:

i. Fixed capital can be determined by the type of business. As the company mentioned here (S Limited) is a company which is into manufacturing, it will have a large operating cycle which therefore results in a need for a large amount of fixed capital.

ii. The scale of operations of a company also determines the need for investment in assets such as machinery, land, plants and buildings, which requires a large sum of fixed capital.

iii. A growing company or a company which is seeking expansion will need more amount of fixed capital which is the case with S Limited.

Factors affecting working capital requirements will be as follows:

i. The working capital requirements for a company will vary on the type of business it is conducting. As it is a manufacturing firm will, it will have a large operating cycle as goods need to be transformed from raw materials to finished goods. Therefore, the requirement for working capital will be more for this firm.

ii. As this company is conducting large-scale operations, there will be requirements for a large amount of working capital.

iii. The company is looking to expand its business which requires more working capital as it will lead to higher growth prospects.

iv. As the product that is being manufactured by this company is in high demand, the company would need to produce more to meet the requirements. Therefore, there will be a need for a large amount of working capital.

Chapter 9 Financial Management

Multiple Choice Questions

1. The working capital requirement of a business is not likely to be high when?

(a) The nature of business is trading

(b) Scale of operation of a business is small

(c) It is difficult to procure raw material

(d) The rate of inflation is low

Answer: (c) It is difficult to procure raw material

2. Under which of the following circumstances the fixed capital requirement of a business is not likely to be high?

(a) When the raw material is not easily available

(b) Capital intensive techniques of production are used

(c) The growth prospects of a company a high

(d) When the financial alternatives are easily available

Answer: (d) When the financial alternatives are easily available

3. Which of the following statements is not true with regard to the use of fixed capital?

(a) It affects the long-term growth of the business

(b) A large number of funds are involved

(c) The business risk involved is low

(d) The investment decisions are irreversible

Answer: (c) The business risk involved is low

4. Under which of the following situations a company is not likely to issue equity capital?

(a) When the debt service coverage ratio is high.

(b) When the interest coverage ratio is high.

(c) When the cost of debt capital is low.

(d) All of the above

Answer: (d) All of the above

5. If in a particular situation, the earnings per share (EPS) falls with the increased use of debt, it indicates that _____.

(a) The rate of return on investment (Rol) is less than the cost of debt

(b) The rate of return on investment is more than the cost of debt

(c) The cost of debt is less than the rate of return on investment

(d) None of the above

Answer: (a) The rate of return on investment (Rol) is less than the cost of debt

6. When does the earnings per share (EPS) rise with higher debt?

(a) When the rate of return on investment is higher than the rate of interest

(b) When the rate of return on investment is lower than the rate of interest

(c) When the rate of interest is more than the rate of return

(d) None of the above

Answer: (a) When the rate of return on investment is higher than the rate of interest.

7. A higher financial leverage ratio indicates that _____.

(a) The dependency of the firm on the debt is more

(b) The dependency of the firm on the debt is less

(c) The proportion of equity in the total capital is high

(d) None of the above

Answer: (a) The dependency of the firm on the debt is more

8. Which of the following statements is not true?

(a) Increased use of debt increases the financial risk of a business

(b) Increased use of debt decreases the financial risk of a business

(c) Decrease in use of debt increases the financial risk of a business

(d) None of the above

Answer: (b) Increased use of debt decreases the financial risk of a business

9. Which of the following statements is not true?

(a) The cost of debt is higher than the cost of equity

(b) The lender's risk is lower than the equity shareholder's risk

(c) The interest paid on debt is treated as a tax-deductible expense

(d) None of the above

Answer: (a) The cost of debt is higher than the cost of equity

10. Which of the following is not important in financial planning?

(a) It helps in avoiding business shocks and surprises

(b) It helps in coordinating various business functions

(c) If helps to reduce waste, duplication of efforts, and gaps in the planning

(d) It tries to delink the present with the future

Answer: (d) It tries to delink the present with the future

11. Arrange the following steps involved in the process of financial planning in the correct sequence.

(a) Estimation of expected profit, Preparation of a sales forecast, Preparation of financial statements

(b) Preparation of a sales forecast, Preparation of financial statements, Estimation of expected profit

(c) Preparation of a sales forecast, Estimation of expected profit, Preparation of financial statements

(d) Preparation of financial statements, Estimation of expected profit, Preparation of a sales forecast

Answer: (b) Preparation of a sales forecast, Preparation of financial statements, Estimation of expected profit

12. Which of the following is not an objective of financial planning?

(a) Ensuring enough funds are available at the right time

(b) Ensuring excess availability of funds at the right time

(c) Ensuring smooth business operations

(d) All of the above

Answer: (b) Ensuring excess availability of funds at the right time

13. A company must adhere to the provisions of the Companies Act while taking the dividend decision. Identify the related factor of the dividend decision being mentioned in the above line.

(a) Contractual constraints

(b) Legal constraints

(c) Access to capital market

(d) Preferences of shareholders

Answer: (b) Legal constraints

14. Name the process that enables the management to foresee the fund requirements, both the quantum as well as the timing.

(a) Financial management

(b) Capital budgeting decisions

(c) Dividend decision

(d) Financial planning

Answer: (d) Financial planning

15. It is essentially the preparation of a financial blueprint of an organisation's future operations. Identify the related concept.

(a) Financial management

(b) Financial planning

(c) Capital budgeting decisions

(d) Dividend decision

Answer: (b) Financial planning

Chapter 9 Financial Management

Summary

Introduction

• Business Finance = Money or funds available for a business for its operations (that is, for some specific purpose) is called finance. It is indispensable for survival and growth of business, for production and distribution of goods and meeting day to day expenses etc.

• It involves acquiring funds to buy Fixed assets (tangible and intangible) and Raw materials and maintain working capital.

Financial 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.

Aims of Financial Financial Management:

1. Reduce cost of funds procured
2. Keep risks under control
3. Achieve effective employment of fund
4. Ensure availability of sufficient funds while avoiding idle funds

•bjectives of Financial Financial Management

• Primary objective: To maximize wealth of owners in the long run – Wealth Maximization concept.

• 'Owners' of a company are the shareholders.

• 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:

• Investment decision • Financing decision and • Dividend decision

• Market price of a share will increase if benefits from a decision are greater than the cost involved in it.

• The goal of a firm should be to maximize the wealth of owners in the long run.

• Increase in the market price of shares is an indicator of the financial health of a firm.

• Other objectives that help a firm achieve the primary objective are:

Ensure availability of funds at reasonable costs:

Ensure effective utilization of funds:

Ensure safety of funds thro creation of reserves:
Maintain liquidity and solvency:

Financial Decisions

Every company is required to take three main financial decisions which are as follows:

1. Investment Decision

Resources are scarce and can be put to alternate use. A firm must choose where to invest so as to earn the highest possible profits.

Investment decision relates to decisions about how the firm's funds are invested in different assets that is, different investment proposals

Has two components:

• Working Capital Decisions – Short Term investment decisions.
• Capital Budgeting decisions – Long Term investment decisions

Factors affecting Investment Decisions/Capital Budgeting decisions

1. Cash flows of the project: The series of cash receipts and payments over the life of an investment proposal should be considered and analyzed for selecting the best proposal.
2. Rate of Return: The expected returns from each proposal and risk involved in them should be taken into account to select the best proposal.
3. Investment Criteria Involved: The various investment proposals are evaluated on the basis of capital budgeting techniques. These involve calculation regarding investment amount, interest rate, cash flows, rate of return etc.

2. Financing Decision

• These are decisions w.r.t quantum of finance or composition of funds from various longterm sources.(short term = working capital Financial Management)
• Financing decisions involve: a) Decision whether or not to use a combination of ownership and borrowed funds. b) Determining their precise ratio.
• Firm needs a judicious mix of debt and equity as :
• Debt involves 'Financial Risk' = risk of default on payment of interest on borrowed funds and the repayment of the principle amount whereas
• Shareholders' funds involve no fixed commitment w.r.t payment of returns or repayment of capital.
• Ownership fund vs. Debt fund: They can be compared on the basis of factors such as examples, interest/dividend payout and repayment of principle, tax

deductibility, and risk and floatation costs.

Factors Affecting Financing Decision

1. Cost: The cost of raising funds from different sources are different. The cheapest source should be selected.
2. Risk: The risk associated with different sources is different. More risk is associated with borrowed funds as compared to owner's fund as interest is paid on it and it is repaid also, after a fixed period of time or on expiry of its; tenure.
3. Flotation Cost: The costs involved in issuing securities such as brokers commission, underwriters' fees, expenses on prospectus etc. are called flotation costs. Higher the flotation cost, less attractive is the source of finance.
4. Cash flow position of the business: In case the cash flow position of a company is good enough then it can easily use borrowed funds and pay interest on time.
5. Control Considerations: In case the existing shareholders want to retain the complete control of business then finance can be raised through borrowed funds but when they are ready for dilution of control over business, equity can be used for raising finance.
6. State of Capital Markets: During boom, finance can easily be raised by issuing shares but during depression period, raising finance by means of debt is easy.
7. Period of Finance: For permanent capital requirement, Equity shares must be issued as they are not to be paid back and for long and medium term requirement, preference shares or debentures can be issued.

3. Dividend Decision

• Dividend is that portion of divisible profits that is distributed to the owners i.e. the shareholders. It results in current income for the shareholders.

• Retained earnings= proportion of profits kept in, that is, reinvested in the business for the business.

• Dividend decision= whether to distribute earnings to shareholder as dividends or retain earnings to finance long-term profits of the firm. Must be done keeping in mind the firms overall objective of maximizing the shareholders wealth.

Factors affecting Dividend Decision

1. Earnings: Companies having high and stable earning could declare high rate of dividends as dividends are paid out of current and paste earnings.
2. Stability of Dividends: Companies generally follow the policy of stable dividend. The dividend per share is not altered and changed in case earnings

change by small proportion or increase in earnings is temporary in nature.
3. Growth Prospects: In case there are growth prospects for the company in the near future them it will retain its earning and thus, no or less dividend will be declared.
4. Cash Flow Positions: Dividends involve an outflow of cash and thus, availability of adequate cash is for most requirement for declaration of dividends.
5. Preference of Shareholders: While deciding about dividend the preference of shareholders is also taken into account. In case 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 then more dividends can be declared by the company.
7. Issue of bonus shares: Companies with large reserves may also distribute bonus shares to increase their capital base as it signifies growth of the company and enhances its reputation also.
8. 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.

Financial Planning

• It involves 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.
• Objectives of Financial Planning:
• To ensure availability of funds whenever they are required o Includes estimation of the funds required for different purposes (long term assets/working cap requirement)
• Estimate the time at which these funds need to be made available.
• Specify sources of these funds.
• To see that the firm does not raise resources unnecessarily:
• Shortage of funds => firm cannot meet its payment obligations.
• Surplus funds => do not earn returns but adds to costs.

Importance of Financial Planning

1. To ensure availability of adequate funds at right time.

2. To see that the firm does not raise funds unnecessarily.
3. It provides policies and procedures for the sound administration of finance function.
4. It results in preparation of plans for future. Thus new projects can he under taken smoothly.
5. It attempts to achieve a balance between inflow and outflow of funds. Adequate liquidity is ensured throughout the year.
6. It serves as the basis of financial control. The Financial Management attempts to ensure utilization of funds in tune with the financial plans.

Capital Structure

• On the basis of ownership, funds => owners funds + borrowed funds.
• Owners funds = equity share capital + preference share capital + reserves and surpluses + retained earnings = EQUITY
• Borrowed funds = loans + debentures + public deposits = DEBT
• Capital Structure = The mix of long-term sources of funds
• Refers to the proportion of debt and equity used for financing the operations of a business.
• Cost and risk- Debt Vs Equity:
• Cost of Debt is lower than cost of equity but Debt is more risky than equity.
• Cost of debt < cost of equity as lenders risk < owners risk.
• Lender earns an assured interest and repayment of capital..
• Interest on debt is a tax deductible expense so brings down the tax liability for a business whereas dividends are paid out of profit after tax.
• Debt is more risky for the business as it adds to the financial risk faced by a business.
• Any default w.r.t payment of interest or repayment of principle amt 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

Factors Affecting Capital Structure

i. Cash flow position:

a. The size of the projected cash flows must be considered before deciding the

capital structure of the firm. If there is sufficient cash flow, debt cab be used.
b. It must cover fixed payment obligations w r t:
i. Normal business operations ii. Investment in fixed assets iii. Meeting debt service commitments as well as provide a sufficient buffer.

ii. Interest coverage ratio :

a. Higher the Interest coverage ratio which is calculated as follows: EBIT/ Interest, lower shall be the risk of the company failing to meet its interest payment obligations.
b. Low Interest coverage ratio => debt ≠ used.

iii. Debt Service Coverage Ratio:

a. Debt service coverage ratio = Profit after tax + Depreciation + Interest + Non Cash exp. Pref. Div + Interest + Repayment obligation
b. A higher Debt service coverage ratio, in which the cash profits generated by the operations are compared with the total cash required for the service of debt and the preference share capital, the better will the ability of the firm to increase debt component in the capital structure.
c. Low Debt service coverage ratio => debt ≠ used.

iv. Return On Investment

a. 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.

v. Cost Of Debt

a. More debt can be used if cost of Debt is low.

vi. Tax Rate

a. A higher tax rate makes debt relatively cheaper and increases its attraction as compared to equity.

vii. Cost Of Equity

a. when the company uses more debt, the financial risk faced by equity holders increase so their desired rate of return increases.
b. If debt is used beyond a point, cost of equity may go up sharply and share price may decrease in spite of increased EPS.

viii. Floatation Cost

a. Cost of Public issue is more than the floatation cost of taking a loan.
b. The floatation cost may affect the choice between debt and equity and hence the capital structure

ix. Risk Consideration:

a. The total risk of business 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.

x. Flexibility:

a. If the firm uses its debt potential, it loses the flexibility to use more debt.

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

xi. Control:

a. Debt normally does not cause dilution of control whereas a public issue makes the firm vulnerable to takeovers.

b. To retain control, firm should issue debt.

Fixed Capital

Fixed capital refers to investment in long-term assets. Investment in fixed assets is for longer duration and they must be financed through long-term sources of capital. Decisions relating to fixed capital involve huge capital funds and are not reversible without incurring heavy losses.

Factors Affecting Requirement of Fixed Capital

1. Nature of Business: Manufacturing concerns require huge investment in fixed assets & thus huge fixed capital is required for them but trading concerns need less fixed capital as they are not required to purchase plant and machinery etc.

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

For Example – A large scale steel enterprise like TISCO requires large investment as compared to a mini steel plant.

3. Choice of Technique: An organization using capital intensive techniques requires more investment in plant & machinery as compared to an organization using labour intensive techniques.

4. Technology upgradation: Organizations using assets which become obsolete faster require more fixed capital as compared to other organizations.

5. Growth Prospects: Companies having more growth plans require more fixed capital. In order to expand production capacity more plant & machinery are required.

6. Diversification: In case a company goes for diversification then it will require more fixed capital to invest in fixed assets like plant and machinery.

7. Distribution Channels: The firm which sells its product through wholesalers and retailers requires less fixed capital.
8. Collaboration: If companies are under collaboration, Joint venture, then they need less fixed capital as they share plant & machinery with their collaborators.

Working Capital

Working Capital refers to the capital required for day to day working of an organization. Apart from the investment in fixed assets every business organization needs to invest in current assets, which can be converted into cash or cash equivalents within a period of one year. They provide liquidity to the business. Working capital is of two types – Gross working capital and Net working capital. Investment in all the current assets is called Gross Working Capital whereas the excess of current assets over current liabilities is called Net Working Capital. Following are the factors which affect working capital requirements of an organization:

l. Nature of Business: A trading organization needs a lower amount of working capital as compared to a manufacturing organization, as trading organization undertakes no processing work.
2. Scale of Operations: An organization operating on large scale will require more inventory and thus, its working capital requirement will be more as compared to small organization.