

## MODULE 4

# FINANCIAL MANAGEMENT

### Financial Management

- Associated with planning and controlling a firm's financial resources
- It is concerned with acquiring, financing, and managing assets to accomplish the overall goal of a business enterprise

### Importance of financial management

1. Taking care not to over invest in fixed assets
2. Balancing cash out-flows with cash in-flows
3. Ensuring that there is sufficient level of short-term working capital
4. Setting sales revenue targets that will deliver growth
5. Increasing gross profit by setting the correct pricing for product and services
6. Tax planning that will minimize the taxes a business has to pay

## Objectives of financial management

1. **Profit maximization** : The main objective of financial management is profit maximization. The finance manager tries to earn maximum profits for the company in the short-term and the long-term. He cannot guarantee profits in the long term because of business uncertainties. However, a company can earn maximum profits even in the long-term, if:-
  - i. The Finance manager takes proper financial decisions.
  - ii. He uses the finance of the company properly.
2. **Wealth maximization** : Wealth maximization (shareholders' value maximization) is also a main objective of financial management. Wealth maximization means to earn maximum wealth for the shareholders. So, the finance manager tries to give a maximum dividend to the shareholders. He also tries to increase the market value of the shares. The market value of the shares is directly related to the performance of the company. Better the performance, higher is the market value of shares and vice-versa. So, the finance manager must try to maximise shareholder's value.
3. **Proper estimation of total financial requirements**: Proper estimation of total financial requirements is a very important objective of financial management. The finance manager must estimate the total financial requirements of the company. He must find out how much finance is required to start and run the company. He must find out the fixed capital and working capital requirements of the company. His

estimation must be correct. If not, there will be shortage or surplus of finance. Estimating the financial requirements is a very difficult job. The finance manager must consider many factors, such as the type of technology used by company, number of employees employed, scale of operations, legal requirements, etc.

4. **Proper mobilisation:** Mobilisation (collection) of finance is an important objective of financial management. After estimating the financial requirements, the finance manager must decide about the sources of finance. He can collect finance from many sources such as shares, debentures, bank loans, etc. There must be a proper balance between owned finance and borrowed finance. The company must borrow money at a low rate of interest.
5. **Proper utilisation of finance:** Proper utilisation of finance is an important objective of financial management. The finance manager must make optimum utilisation of finance. He must use the finance profitable. He must not waste the finance of the company. He must not invest the company's finance in unprofitable projects. He must not block the company's finance in inventories. He must have a short credit period.
6. **Proper coordination:** Financial management must try to have proper coordination between the finance department and other departments of the company.

7. **Reduce cost of capital:** Financial management tries to reduce the cost of capital. That is, it tries to borrow money at a low rate of interest. The finance manager must plan the capital structure in such a way that the cost of capital is minimized.
8. **Reduce operating risks:** Financial management also tries to reduce the operating risks. There are many risks and uncertainties in a business. The finance manager must take steps to reduce these risks. He must avoid high-risk projects. He must also take proper insurance.
9. **Prepare capital structure:** Financial management also prepares the capital structure. It decides the ratio between owned finance and borrowed finance. It brings a proper balance between the different sources of capital. This balance is necessary for liquidity, economy, flexibility and stability.

## Functions of financial management

1. Estimating capital requirements
2. Determining capital structure
3. Estimating cash flow
4. Investment decisions
5. Dividend Decision
6. Checking the financial performances

## Capital

- Saved up financial wealth, especially which is used to start or maintain a business
  - a. Fixed capital
  - b. Working capital

### Fixed capital

- Long term funds are required to create production facilities through purchase of fixed assets such as land, plant and machinery, building, furniture etc.
- Investments in these assets represent that part of firm's capital which is blocked on permanent or fixed basis

### Working capital

- Funds required for the short term purpose like purchase of raw materials, salary for workers, other day to day expenses
- Working capital is required to keep flow of production smooth and continuous

## Factors affecting working capital

### **1. Nature of the business**

The requirement of working capital depends on the nature of business. The nature of business is usually of two types: Manufacturing

Business and Trading Business. In the case of manufacturing business it takes a lot of time in converting raw material into finished goods. Therefore, capital remains invested for a long time in raw material, semi-finished goods and the stocking of the finished goods.

Consequently, more working capital is required. On the contrary, in case of trading business the goods are sold immediately after purchasing or sometimes the sale is affected even before the purchase itself. Therefore, very little working capital is required. Moreover, in case of service businesses, the working capital is almost nil since there is nothing in stock.

## **2. Scale of Operation**

There is a direct link between the working capital and the scale of operations. In other words, more working capital is required in case of big organisations while less working capital is needed in case of small organisations.

## **3. Length of period of manufacture/ Production Cycle**

Production cycle means the time involved in converting raw material into finished product. The longer this period, the more will be the time for which the capital remains blocked in raw material and semi-manufactured products.

Thus, more working capital will be needed. On the contrary, where period of production cycle is small, less working capital will be needed.

#### **4. Operating Efficiency**

Operating efficiency means efficiently completing the various business operations. Operating efficiency of every organisation happens to be different.

Some such examples are: (i) converting raw material into finished goods at the earliest, (ii) selling the finished goods quickly, and (iii) quickly getting payments from the debtors. A company which has a better operating efficiency has to invest less in stock and the debtors.

Therefore, it requires less working capital, while the case is different in respect of companies with less operating efficiency.

#### **5. Terms of purchase and sales**

If raw material and other inputs are easily available on credit, less working capital is needed. On the contrary, if these things are not available on credit then to make cash payment quickly large amount of working capital will be needed.

OR

If the firm purchases raw materials and other needs on credit and sells on cash basis, it requires less working capital. If it buys on cash basis and sells its product on credit, it will need a large amount of working capital because of instant payments and slow collections.

#### **6. Seasonality of operation**

Some goods are demanded throughout the year while others have seasonal demand. Goods which have uniform demand the whole year their

production and sale are continuous. Consequently, such enterprises need little working capital.

On the other hand, some goods have seasonal demand but the same are produced almost the whole year so that their supply is available readily when demanded.

Such enterprises have to maintain large stocks of raw material and finished products and so they need large amount of working capital for this purpose. Woollen mills are a good example of it.

## **7. Importance and Size of labour force**

If project is labour intensive, large amount of working capital is required.

## **8. Availability of Raw Material**

Availability of raw material also influences the amount of working capital. If the enterprise makes use of such raw material which is available easily throughout the year, then less working capital will be required, because there will be no need to stock it in large quantity.

On the contrary, if the enterprise makes use of such raw material which is available only in some particular months of the year whereas for continuous production it is needed all the year round, then large quantity of it will be stocked. Under the circumstances, more working capital will be required.



## **9. Market condition**

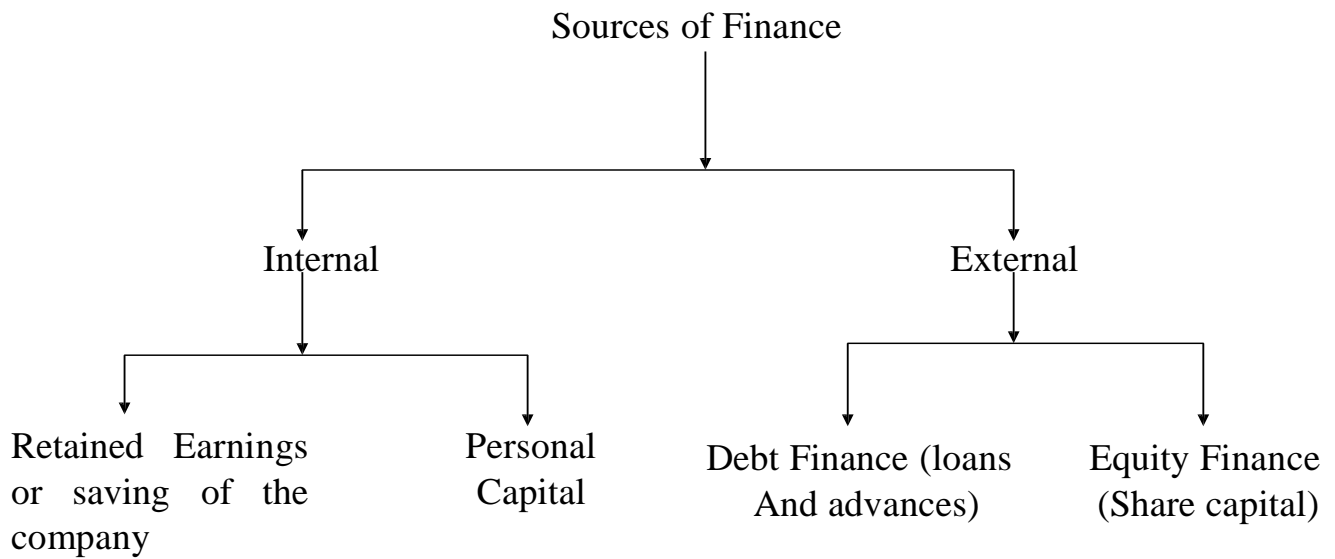
### **1. Level of Competition:**

High level of competition increases the need for more working capital. In order to face competition, more stock is required for quick delivery and credit facility for a long period has to be made available.

### **2. Inflation:**

Inflation means rise in prices. In such a situation more capital is required than before in order to maintain the previous scale of production and sales. Therefore, with the increasing rate of inflation, there is a corresponding increase in the working capital.

## METHODS OF FINANCING



## **SOURCES OF FINANCE**

### **1. Shares**

- Owned capital of a company divided into a large number of equal parts or units. Each such part having the same face value is called share
- Share is one unit into which the total capital is divided
- The amount collected by the company from the public towards its capital, collectively known as share capital and individually known as share
- Generally shares are issued at the time of starting of a new business
- Shareholders are part owners of the company

A public company may have two types of shares:

#### **a. Preference Shares**

- A person holding these shares is entitled to get fixed rate of dividend. He gets his rate of dividend before any amount paid to the ordinary shareholders.

#### **b. Equity Shares**

- A equity share, commonly referred to as ordinary shares
- These shares get there dividend only after payment of the fixed dividend on preference shares
- The advantage of the holders of the ordinary share is that there is no limit of dividend, and thus they may get higher dividend.
- If there is a loss, then ordinary shareholders do not get any dividend

## **2. Debentures (also called Bonds)**

- Is a unit of loan amount
- When a company intends to raise the loan amount from the public, it issues debentures
- It is an acknowledgement of the loan received by the company equal to the nominal value of the debenture
- Debenture holder is the creditor of the company (get credit amount + fixed interest)
- Debentures are generally freely transferable by the debenture holder. Debenture holders have no rights to vote in the company's general meetings of shareholders, but they may have separate meetings or votes e.g. on changes to the rights attached to the debentures. The interest paid to them is a charge against profit in the company's financial statements.

## **3. Public Deposits**

Public deposits are an important source of financing the medium-term and long-term requirements of a company. The term 'public deposit' implies any money received by a company through the deposits or loans collected from the public. The public includes the general public, employees and shareholders of the company but excludes the money received in the form of shares and debentures.

Company has to accept deposits from public minimum for 6 months and maximum for 3 years.

The companies offer 9 to 10 percent interest rate over public deposits

for two years while 10 to 11 percent interest rate is offered for the three year deposits. There are rules regulating the fixed deposits.

**The various advantages of public deposits enjoyed by the companies are:**

- There is no involvement of restrictive agreement
- The process involved in gaining public deposit is simple and easy
- The cost incurred after tax is reasonable
- Since there is no need to pledge security for public deposits, the assets of firm that can be mortgaged can be preserved

**The disadvantages of public deposits from the company's point of view are:**

- The maturity period is short enough
- Limited fund can be obtained from the public deposits

**The advantages of public deposits enjoyed by the investors are:**

- The interest rate is higher than the other financial investment instruments
- The fund maturity period is short

**The disadvantages of public deposits from the investors' point of view are:**

- The interest that is charged on the public deposits does not enjoy tax exemption
- There is no pledging of security against public deposits

#### **4. Loans from Banks**

#### **5. Bank Overdrafts**

An extension of credit from a lending institution when an account reaches zero. An overdraft allows the individual to continue withdrawing money even if the account has no funds in it. Basically the bank allows people to borrow a set amount of money.

#### **6. Trade Credit**

An agreement where a customer can purchase goods on account (without paying cash), paying the supplier at a later date. Usually when the goods are delivered, a trade credit is given for a specific amount of days - 30, 60 or 90. Jewellery businesses sometimes extend credit to 180 days or longer. Basically, this is a credit a company gives to another for the purchase of goods and services.

Example:

The operator of an ice cream stand may sign a franchising agreement, under which the distributor agrees to provide ice cream stock under the terms "Net 60" with a ten percent discount on payment within 30 days, and a 20% discount on payment within 10 days. This means that the operator has 60 days to pay the invoice in full. If sales are good within the first week, the operator may be able to send a cheque for all or part of the invoice, and make an extra 20% on the ice cream sold. However, if sales are slow, leading to a month of low cash flow, then the operator may decide to pay within 30 days, obtaining a 10% discount, or use the money another 30 days and pay the full invoice

amount within 60 days.

The ice cream distributor can do the same thing. Receiving trade credit from milk and sugar suppliers on terms of Net 30, 2% discount if paid within ten days, means they are apparently taking a loss or disadvantageous position in this web of trade credit balances. Why would they do this? First, they have a substantial mark-up on the ingredients and other costs of production of the ice cream they sell to the operator. There are many reasons and ways to manage trade credit terms for the benefit of a business. The ice cream distributor may be well-capitalized either from the owners' investment or from accumulated profits, and may be looking to expand his markets. They may be aggressive in attempting to locate new customers or to help them get established. It is not on their interests for customers to go out of business from cash flow instabilities, so their financial terms aim to accomplish two things:

- Allow start up ice cream parlours the ability to mismanage their investment in inventory for a while, while learning their markets, without having a dramatic negative balance in their bank account which could put them out of business. This is in effect, a short term business loan made to help expand the distributor's market and customer base.
- By tracking who pays, and when, the distributor can see potential problems developing and take steps to reduce or increase the allowed amount of trade credit he extends to prospering or exposure to losses from customers going bankrupt who would never pay for the ice cream delivered.

## **7. Retained Earnings**

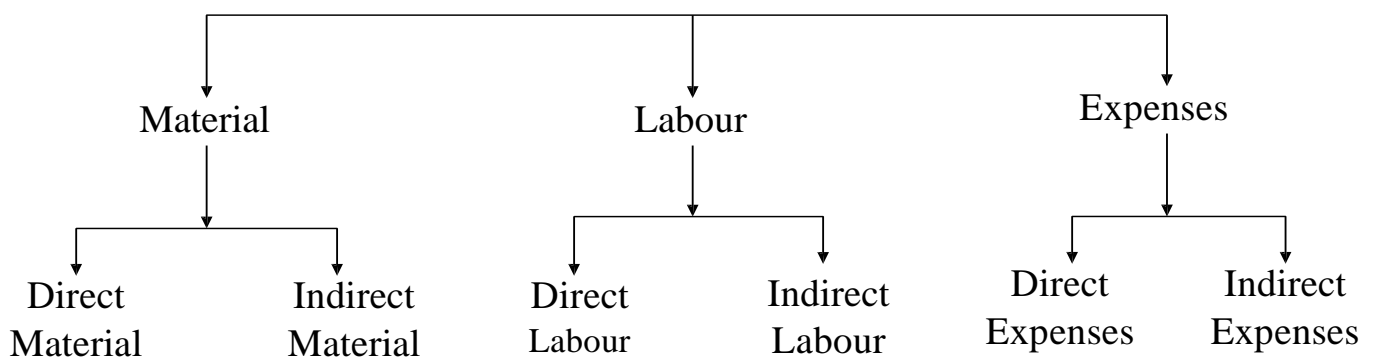
The company does not distribute all its earnings amongst the shareholders as dividends. The portion of the profit which is not distributed among the shareholders but is retained and is used in business is called retained earnings



## COST MANAGEMENT

- **Cost** is the amount of expenditure (actual or notional) incurred on or attributable to a specified article, product or activity
- **Cost management** is the process by which companies control and plan the costs involved in a business
- **Cost accounting** is the process of calculating the cost of an article as a basis to fix its selling price
- **Cost center** is defined as location, person, or item of equipment to which cost may be established
- **Cost unit** is the unit of product, service or a combination of them in relation to which cost are ascertained. E.g.: Tonne for steel in steel industries

### ELEMENTS OF COST AND COST LADDER



There are broadly three elements of cost - (1) material, (2) labour and (3) expenses.:

## **MATERIALS**

The substance from which the product is made is known as material. It may be in a raw state-raw material, e.g., timber for furniture and leather for shoe, etc. It may j also be in manufactured state-components, e.g., battery for car, speaker for radio, etc. Materials can be direct and indirect.

Direct Material: All materials which become an integral part of the finished j product, the cost of which are directly and completely assigned to the specific physical units and charged to the prime cost, are known as direct material. The following are some of the materials that fall under this category:

- (a) Materials which are specifically purchased; acquired or produced for a particular job, order or process.
- (b) Primary packing material (e.g. carton, wrapping, cardboard, etc.)
- (c) Materials passing from one process to another as inputs.

In order to calculate the cost of material, expenses such as import duties, dock charges, transport cost of materials are added to the invoice price.

Material considered direct at one time may be indirect on other occasion. Nail used in manufacturing wooden box is treated as direct material, but treated as indirect material when used to repair the factory building.

**Indirect Material:** All materials, which cannot be conveniently assigned to specific physical units, are termed as 'indirect material'. Such commodities do not form part of the finished products. Consumable stores, lubrication oil, stationery and spare parts for the machinery are termed as indirect materials.

## **LABOUR**

Human efforts used for conversion of materials into finished products or doing various jobs in the business are known as labour. Payment made towards the labour is called labour cost. It can also be direct and indirect.

**Direct Labour:** Direct labour is all labour expended and directly involved in altering the condition, composition or construction of the product. The wages paid to skilled and unskilled workers for manual work or mechanical work for operating machinery, which can be specifically allocated to a particular unit of production, is known as direct wages or direct labour cost. Hence, 'direct wage' may be defined as the measure of direct labour in terms of money. It is specifically and conveniently traceable to the specific products Wages paid to the goldsmith for making gold ornament is an example of direct labour.

**Indirect Labour:** Labour employed to perform work incidental to production of goods or those engaged for office work, selling and distribution activities are

known as 'indirect labour'. The wages paid to such workers are known as 'indirect wages' or indirect labour cost.

Example: Salary paid to the driver of the delivery van used for distribution of the product.

## **EXPENSES**

All expenditures other than material and labour incurred for manufacturing a product or rendering service are termed as 'expenses'. Expenses may be direct or indirect.

**Direct Expenses:** Expenses which are specifically incurred and can be directly and wholly allocated to a particular product, job or service are termed as 'direct expenses'. Examples of such expense are: hire charges of special machinery hired for the job, carriage inward, royalty, cost of special and specific drawings, etc. These are also known as 'chargeable expenses'.

**Indirect Expenses:** All expenses excluding indirect material and indirect labour, which cannot be directly and wholly attributed to a particular product, job or service, are termed as 'indirect expenses'. Some examples of such expenses are: repairs to machinery, insurance, lighting and rent of the buildings.

## Classification of Cost

### Classification according to elements

- Material
- Labour
- Expenses

### Classification according to nature

- Direct and indirect material
- Direct and indirect labour
- Direct and indirect expenses

### Classification according to behaviour

- Fixed costs (e.g.: insurance charges, management salary)
- Variable costs (e.g.: direct material cost, workers labour, power)
- Semi-variable costs (e.g.: management cost, supervisory cost)

### Classification according to functions

- Production or manufacturing costs
- Administrative costs (e.g.: salaries, printing and stationary, office telephone bill, rent, insurance etc.)
- Selling costs (e.g.: advertising, sales staff salary etc.)
- Distribution costs
- Research and development costs

## COMPONENTS OF COST

- a. Prime Cost (basic, first or flat cost)

*Direct material cost + Direct labour cost + direct expenses*

- b. Factory Cost (works cost, production or manufacturing cost)

*Prime Cost + Factory Overhead (involves indirect cost of indirect materials, indirect labour and indirect expenses)*

- c. Cost of Production (administration cost or office cost)

*Factory cost + Administration overhead*

- d. Total Cost (cost of sales)

*Cost of production + Selling and Distribution overhead*

- e. Selling price

*Selling price = Total cost + profit*

					Selling Price	
					Cost of Sales	Profit
					Selling & distribution Overheads	Cost of Sales
					Cost of Production	
					Office Overheads	
					Factory Cost	
					Factory Overheads	
Prime Cost			Prime Cost	Factory Cost	Cost of Production	
	Direct Expenses					
	Direct Labour					
	Direct Material					