5.1 FINANCIAL MANAGEMENT

"Financial Management is the *management of finance of an organization in order to achieve financial objectives*". It is concerned with procurement, allocation and control of financial resources of a concern.

There are three elements of financial management –

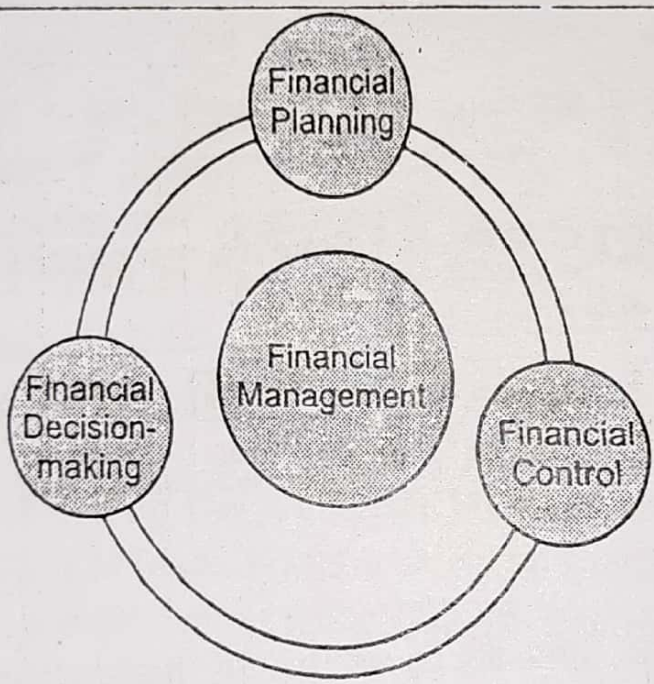

Fig. 5.1: Financial Management

(1) **Financial Planning:** Financial Planning ensures that sufficient funds are available at the right time to meet the needs of the business.

(2) **Financial Control:** Financial control ensures –

- efficient assets utilization,
- security of businesses assets, and
- shareholder's interest is served.

(3) **Financial Decision-making:** Financial decision making is related to investment, financing and dividends. It is related to taking decisions like –

- Where and how much to invest ?
- How to finance investments ?
- Whether profits should be retained or distributed to shareholders via dividends ?

5.1.1 Objectives of Financial Management

(W-09) (4M) (S-11) (3M)

Efficient Financial management requires the existence of some objectives, which are as follows:

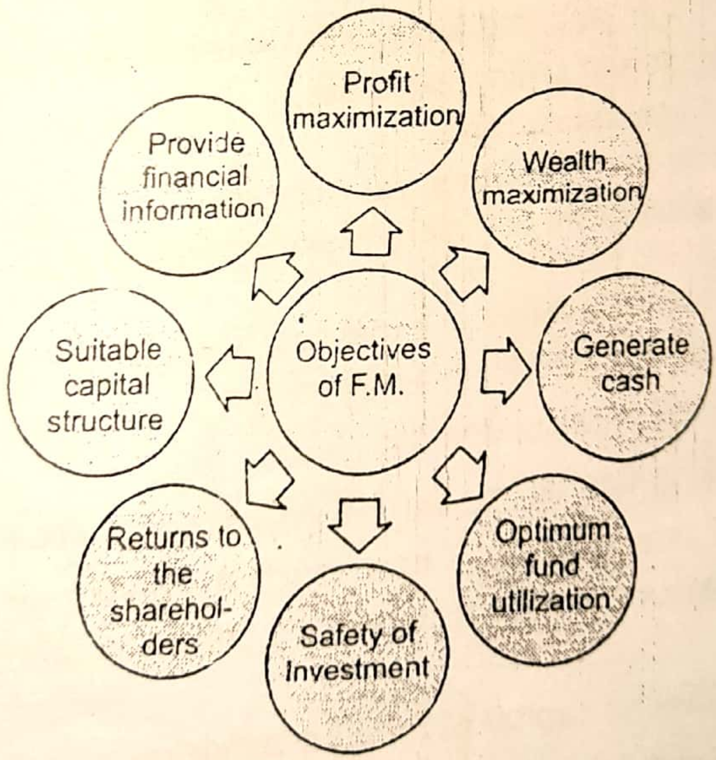

Fig. 5.2: Objectives of Financial Management

1. *Profit maximization:* Maximization of profits in long run is the main objective of financial management.
2. *Wealth Maximization:* Investors purchase shares, with a hope to earn high profit on it. It is, therefore, the goal of the financial management to ensure its shareholders that the value of their shares will be maximized in the long run. It is possible by increasing - Dividend per share and Earning per share.

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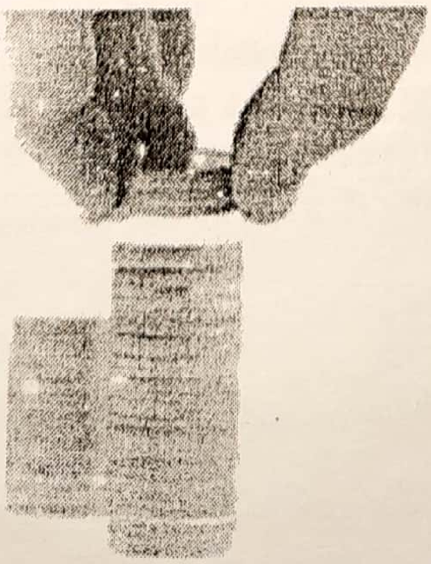
3. To ensure regular and adequate supply of funds by generating cash.
4. To ensure effective, efficient and economical utilization of funds.
5. To ensure safety on investment, by investing funds in sound businesses.
6. To provide sufficient returns to the shareholders.
7. To plan a suitable capital structure (i.e. To maintain appropriate balance between debt and equity capital.)
8. To ensure the availability of timely, relevant and reliable financial information.

5.1.2 Functions of Financial Management (S-11) (3M)

1. Forecast the future financial requirements of the organization considering investments, expansion etc.
2. Determine the sources from which finance can be obtained.
3. Motivate the existing sources of finance to provide further finance in the future when required.
4. Decide whether to finance a new plant or not.
5. Decide basis for the expenditure of funds.
6. Allocate budget to each department considering their requirements.
7. Keep a check and control over the expenditure.
8. Periodically evaluate the progress of each department.
9. Determine the financial position of the organization after analyzing efficiency.
10. Fix product price giving due consideration to profit optimization.
11. Analyze and interpret the financial information about the organization, in view of planning the financial requirements.
12. Decide whether profits earned by the business should be retained or distributed to shareholders via dividends.

5.2 CAPITAL GENERATION AND MANAGEMENT



The wealth invested in business to generate income is called capital. Capital is required to start the business, run the business and expand the business. Hence it is very important to generate the required capital from various sources as and when required and manage it efficiently. If the capital is not managed properly huge losses may be incurred.

Fixed capital management ensures that a company has sufficient funds to purchase fixed assets required for starting, improving, expanding or diversifying the business.

Working capital management ensures a company has sufficient cash flow in order to meet its short-term debt obligations and operating expenses.

5.2.1 Types of Capital

(W-09) (3M) (S-10) (8M) (S-11) (4M)

The capital required for a business is of two types:

1. Fixed Capital.
2. Working Capital.

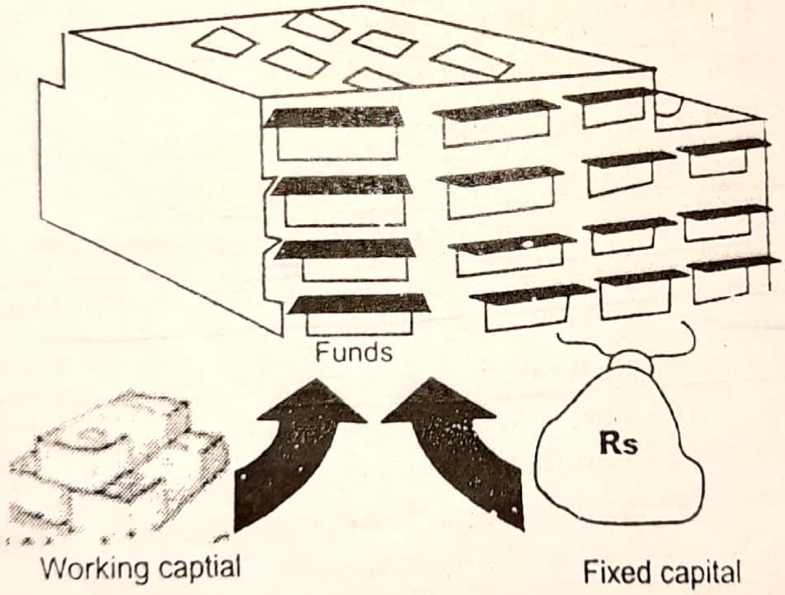


Fig. 5.3: Types of Capital

Fixed or Block capital:

To start an enterprise some capital is to be invested in fixed assets. Thes assets are used over and over again for a number of years.

" The capital invested in assets of durable nature for repeated use over a lon period is called fixed capital". It stays in the business almost permanently. Fixe capital is required for –

1. Land,
2. Building,
3. Equipment and machinery,
4. Tools,

5. Furniture,
6. Power and electric supply,
7. Water supply and drainage etc.

The amount of fixed capital required varies from industry to industry. Some businesses require high fixed-capital investment. For example- power generation, telecommunications, oil exploration, refineries, railways, steel industry etc.

On the other hand software industry, trading and financial firms, banks, courier services, labour intensive industries needs less fixed capital. They require more working capital.

1. Working Capital (Current/Revolving Capital):

"The money required to meet day-to-day needs and expenditures is called working capital".

Working capital is required for –

1. Purchase of raw material, spare parts and supplies,
2. Maintaining stocks of partly finished and finished products,
3. Payment of employee salaries,
4. Payment of light and telephone bills, water charges, municipality bills etc.
5. Advertisement and selling expenses,
6. Payment of insurance, rent.
7. To give credit to distributors, retailers etc.
8. Machines, equipment and plant maintenance costs,
9. Stationery,
10. Transportation and shipping expenses,
11. Cash to be maintained for emergency etc.

The working capital is calculated as:

Working Capital = Current Assets – Current Liabilities

Working capital lets you know how much money is on hand for day to day operations. It's a measure of both a company's efficiency and its short-term financial health.

The amount of working capital required depends on –

(a) ***Time required for manufacturing/selling the product:*** If time required for manufacturing the product is long, working capital required is more (e.g. it takes years to fabricate a Turbine and Generator set of power plant or to build a dam). In case of departmental stores the products are held for a short duration (usually few days) hence less working capital is required.

(b) ***Credit facilities offered by suppliers:*** Usually a credit of one to three months is offered by the suppliers. If the suppliers do not offer any credit then working capital required is more.

(c) ***Seasonal fluctuations:*** In some businesses there are lots of fluctuations in the raw material/finished product prices. In such case, the firm may need more working capital for keeping stock of material to take advantages of price fluctuations for example gold, silver, copper, agricultural produce etc.

(d) ***Credit facilities offered to the customers:*** If the company offers any credit facilities to its customers, working capital required will be more.

5.2.2 Sources of Finance (S-11) (4M)

The various sources of finance can be classified in to two categories –

(a) Sources of Fixed Capital (S-10, W-10) (4M)

Fixed capital can be financed through –

1. Shares,
2. Long Term Debentures,
3. Loan from Banks,
4. Loan from Financial Institutions,
5. Public Deposits, and
6. Retained Earnings.

(b) Sources of Working Capital (W-09) (3M)

Working capital can be divided in to two types –

(i) Working Capital for Regular Work and,

(ii) Seasonal Working Capital

(i) Working Capital for Regular Work can be financed through -

1. Shares,
2. Medium Term Debentures,
3. Loan from Banks,
4. Public Deposits,
5. Retained Earnings,
6. Franchising,
7. Trade Credit and,
8. Customer's Advance.

(ii) Seasonal Working Capital can be financed through –

1. Cash Credit,
2. Overdraft
3. Discounting of Bill and,
4. Bank Loans.

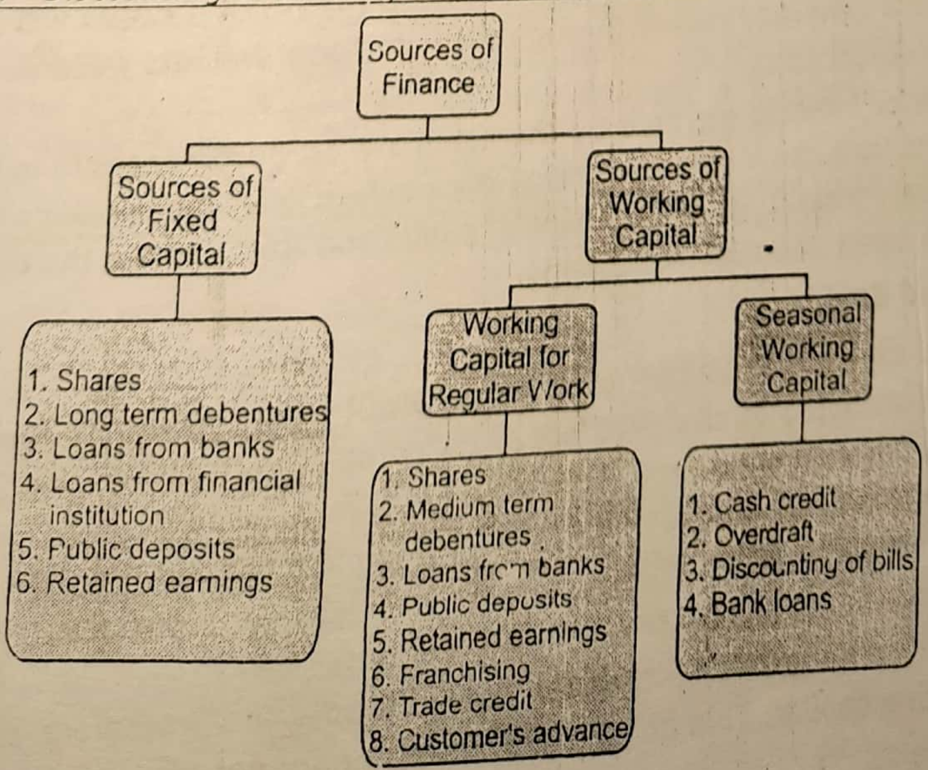


Fig. 5.4: Sources of Finance

The various Sources of Finance are discussed below:

1. Shares

A joint stock company divides the capital required into units of equal denomination of ₹ 1, 2, 5 or 10. Each unit is called a share. These units are offered for sale to raise the capital. Those who buy shares of the company are called shareholders. By acquiring shares in the company they become owners of the company. The shareholders have equal claim on the company's profit and equal obligation for the company's losses.

Generally shares are issued at the time of starting of new business or expanding the existing company.

Shares are of two types-(a) Preference shares and (b) Equity shares.

(a) Preference shares: Preference shares are the shares which carry preferential rights over equity shares. A person holding these shares gets his dividend before any amount is paid to the equity shareholders. In the event of a company bankruptcy, preference shareholders have a right to be paid company assets first. A person holding these shares is entitled to get fixed rate of dividend, but does not have a voting right.

Preference shares are of the following four types:

(i) ***Cumulative preference shares:*** If the profit is not sufficient to pay the fixed dividend in any year then the deficit is paid up from the profit of the next year.

(ii) ***Non-cumulative preference shares:*** If the profit of any year is insufficient the dividend is skipped and not paid in subsequent years.

(iii) ***Participating preference shares***: The shareholders receive fixed dividend plus extra earnings based on certain conditions.

(iv) ***Convertible preference shares***: These shares can be exchanged for a specified number of equity shares after certain period.

(b) Equity shares: *The equity shareholders* get dividend only after payment of fixed dividend to preference shareholders. There is no fixed limit of dividend. They may get higher dividend if the profit is more. If there is a loss, then ordinary shareholders do not get any dividend.

Equity shareholders have the right to take part in the management of the company. Investment in equity shares is most risky but if the company prospers the investors get very high returns.

2. Debentures

Debenture is a medium to long-term debt instrument, bearing fixed interest issued by a company. It may be or may not be secured by any physical asset. Unsecured debentures are backed only by the creditworthiness and reputation of the issuer.

If a company wants to borrow a large amount of fund for a medium to long term and fixed period from the general public, it can do so by issuing debentures. The total amount to be borrowed is divided into units of fixed amount say of ₹ 100/- or ₹ 1000/-each. These units are called Debentures. These are then offered to the public for subscription. The subscribers get debenture certificates in which terms and conditions are specified. Debenture-holders have no liabilities.

The various types of debentures are –

(a) **Redeemable Debentures:** These debentures are repayable on a pre-determined date.

(b) **Irredeemable Debentures:** A company is not bound to repay the amount during its life time. The company has to redeem such debentures if it fails to pay the interest.

(c) **Convertible Debentures:** The debenture holders have the option to convert their debentures into equity shares at a pre decided time and ratio.

(d) **Non-convertible Debentures:** These debentures cannot be converted into shares.

Difference between Shares and Debentures:

Sr. No.	Shares	Debentures
1.	Shareholders are the owners of the company.	Debenture holders are creditor of the company
2.	A shareholder can take part in the management of the company; he/she has voting right.	A debenture holder cannot take part in the management of the company; he/she does not have voting right
3.	Shareholders get dividend.	Debenture holders get interest.
4.	The dividend declared is not fixed and depends on the profitability of the company.	The interest paid to debenture holders is fixed. Whether there is profit or loss will not affect the payment of interest on debentures.
5.	Shares cannot be converted in to debentures.	Convertible debentures can be converted in to shares.
6.	Investment in shares is a high risk high returns investment.	Investment in debentures is low risk low returns investment.
7.	In case of liquidation shareholders capital will be paid back only after repaying the loan of debenture holders.	Debentures will get priority in getting the money back as compared to shareholder in case of liquidation of a company.

3. Loans from Banks

A loan is a type of debt. In a loan, the borrower initially receives an amount of money, called the principal, from the lender. The borrower is obligated to repay the principal and interest to the lender at a later time.

Banks grant loans from short to long period based on customer's requirements. Banks give loans against personal guarantee or pledge of assets. The short term loans can be extended if required and long term loans can be repaid early if the need is met. The interest charged is 12 to 13 percent per annum.

Loans can be paid-back in easy installments. Moreover, low interest is charged to small-scale industries and industries in backward areas.

However, usually lots of formalities are to be fulfilled for getting term loans from banks, which makes the borrowing from banks time consuming and inconvenient.

Some of the banks which grant loans are- State Bank of India, Bank of Baroda, Union Bank of India, HDFC Bank, Axis Bank, ICICI Bank, Central Bank of India and Bank of Maharashtra.

4. Loan from Financial Institutions

Financial Institutions established by the Central and State governments give long term loans (10 to 20 years) at reasonable rate of interest. Financial Institutions provides loans only for the fixed capital.

Some of these institutions are- Industrial Finance Corporation of India (IFCI), Industrial Development Bank of India (IDBI), Industrial Credit and Investment Corporation of India (ICICI), Unit Trust of India (UTI), State Finance Corporations, Life Insurance Corporation of India (LIC), General Insurance Corporation of India (GIC), Infrastructure Development Finance Corporation (IDFC) etc.

5. Public Deposits

It is a very convenient method of raising medium term finance for a period ranging between one to three years. The company which wants to raise funds advertises in the newspapers and invites the investors to deposit their savings with it. It declares the rate of interest and the period for which deposits will be accepted. Fixed capital is generally raised through medium term deposits while working capital by short period deposits.

The rate of interest payable by the company on public deposits is two to three percent lower than the interest on loans from banks. Moreover, it helps the company to borrow funds from a larger segment of public and thus reduces the dependence of the company upon financial institutions.

6. Retained Earnings

Retained earnings refer to the portion of profit which is retained by the company rather than distributed to shareholders as dividend. It is also called ploughing back of profits. Generally companies retain their earnings in order to –

- Invest in fixed capital for expansion/improvement,
- Pay off debt or
- Spend the money on research and development.

Moreover, the reserve of capital, built up during the prosperous period can be used as working capital. This helps during recessionary periods.

7. Franchising

If a company has a well known Brand Name, it can use it for generating resources by franchising.

A franchise is a right granted to an individual or group to market a company's product within a certain territory. Under this arrangement, a franchisee pays fees to the franchisor (owner of brand). The fee charged is usually a percentage of the franchisee's turnover. Examples of franchises are McDonald's and Domino's Pizza.

8. Trade Credit

A credit of one month to three months is given by the suppliers on raw material, finished goods, and the like to the customers. This facility reduces the working capital requirement.

9. Cash Credit

Banks give cash credit against security. The borrower can withdraw money up to a sanctioned limit. This limit is called cash credit limit. The borrower can draw, repay and again draw the amount within the sanctioned limit. Interest is charged only on the amount actually withdrawn.

10. Overdraft

Banks give overdraft facility to their creditworthy account holders. Overdraft refers to the money which a customer is allowed to withdraw in excess of the balance in his account. The customer can withdraw extra money up to sanctioned limit. Interest is charged only on the overdrawn money. The account holder has to show a positive balance in his account on the last Friday of every month.

11. Discounting of Bill

Banks offer money by discounting bills of exchange, promissory notes etc. Banks credit money in customer's account after deducting discount on the bills. The amount of discount is equal to the amount of interest for the period of bill.

12. Customer's Advance

It refers to the advance payment made by a customer against the price of the product which will be delivered at a later date. When the value of order is quite large or things ordered are very costly or goods are not easily available Customers are ready to pay advance. (e.g. Advance paid to book a car/bike, flat, aeroplane, turbine, generator etc).