UNIT – 2 (Financial Management)

Financial Management

1. Meaning

Financial Management is the **planning, organizing, directing, and controlling of financial activities** such as procurement and utilization of funds of an organization.

- It deals with **how a business acquires money, how it is used, and how it is managed** to achieve the company's goals.

In short, it is the **science and art of managing money** in a business.

2. Objectives of Financial Management

Financial Management has two types of objectives:

A. Primary Objectives

- **Profit Maximization:** Ensure the company earns maximum profit.
- **Wealth Maximization:** Increase shareholders' wealth by increasing the market value of shares.

B. Secondary Objectives

- Ensure **adequate liquidity** to meet day-to-day expenses.
- Maintain **financial stability** and avoid over-indebtedness.
- Ensure **optimal utilization of funds**.
- Plan for **future financial requirements**.
- Ensure **safety of investment**.

3. Functions of Financial Management

1. **Financial Planning:** Estimating the financial requirements and planning for them.
2. **Financial Control:** Monitoring financial resources to ensure they are used efficiently.
3. **Financial Decision Making:** Decisions related to investment, financing, and dividend.

4. Importance of Financial Management

- Helps in **raising sufficient funds** at the right time.
- Ensures **efficient utilization of funds**.

- Helps **maximize profits** and **shareholder wealth**.
- Maintains **financial discipline** and avoids wastage.
- Helps **evaluate financial performance** using tools like ratio analysis.
- Assists in **risk management and growth planning**.

5. Areas of Financial Management

1. **Investment Decisions:** Deciding where and how to invest funds.
2. **Financing Decisions:** Deciding the mix of equity, debt, and internal finance.
3. **Dividend Decisions:** Deciding the portion of profit to distribute as dividend vs reinvest.
4. **Liquidity Management:** Managing working capital efficiently.

In short:
Financial Management ensures that a business has **enough funds**, **uses them efficiently**, and **maximizes value for shareholders**, while balancing **risk and profitability**.

Need of Finance and Sources of Finance for Enterprises

1. Need of Finance

Finance is considered the **lifeblood of business**. Every enterprise—small or large—requires funds for different purposes. The major needs are:

1. **For Establishment** – to buy land, building, plant, machinery, furniture, etc.
2. **For Working Capital** – to meet day-to-day expenses like raw materials, wages, rent, salaries, and bills.
3. **For Expansion & Growth** – to modernize equipment, expand markets, or diversify into new products.
4. **For Innovation & R&D** – to adopt latest technology, research, and product development.
5. **For Meeting Contingencies** – to face emergencies like accidents, economic slowdown, or stiff competition.
6. **For Legal & Statutory Obligations** – paying taxes, duties, fees, and other government dues.

Thus, **finance is required at every stage**—from starting the enterprise, running operations, expanding, and sustaining growth.

2. Sources of Finance

Sources of finance are classified on the basis of **time period**:

A. Short-Term Sources of Finance (Period: Less than 1 year)

Used for meeting **working capital requirements** (day-to-day needs).

- **Trade Credit:** Credit allowed by suppliers.
- **Bank Overdraft / Cash Credit:** Facility to withdraw more than deposited.
- **Short-term Loans:** Loans from banks for immediate needs.
- **Commercial Papers:** Unsecured promissory notes by large companies.
- **Customer Advances:** Advance received from customers.
- **Installment Credit:** Deferred payment system for goods purchased.

Purpose: Payment of wages, bills, raw materials, and immediate obligations.

B. Medium-Term Sources of Finance (Period: 1 to 5 years)

Used for **modernization, equipment purchase, and development projects**.

- **Term Loans from Banks / Financial Institutions** – repayable in installments over 1–5 years.
- **Hire Purchase:** Assets acquired by paying installments; ownership after final payment.
- **Leasing:** Renting of assets instead of buying.
- **Public Deposits:** Money collected from public for medium period.
- **Venture Capital:** Investment by venture capital firms in innovative businesses.

Purpose: Purchase of machinery, marketing expansion, modernization.

C. Long-Term Sources of Finance (Period: More than 5 years)

Used for **fixed capital requirements** like land, building, plant, and large projects.

- **Equity Shares:** Ownership capital raised from shareholders.
- **Preference Shares:** Carry fixed dividend and preferential rights.
- **Debentures / Bonds:** Debt instruments with fixed interest.
- **Retained Earnings:** Profits reinvested in business.
- **Long-Term Loans:** From banks and financial institutions.
- **Foreign Direct Investment (FDI):** Capital from foreign investors.

- **Government Schemes & Subsidies:** Support from government agencies.

Purpose: Expansion, diversification, R&D, and modernization of business.

3. Summary Table

Duration	Nature of Requirement	Sources of Finance
Short-Term (<1 yr)	Working capital, daily expenses	Trade Credit, Bank Overdraft, Short-Term Loan, Customer Advance, Commercial Paper
Medium-Term (1–5 yrs)	Machinery, modernization, development	Term Loan, Hire Purchase, Leasing, Public Deposits, Venture Capital
Long-Term (>5 yrs)	Land, building, expansion, R&D	Equity Shares, Preference Shares, Debentures, Retained Earnings, Long-Term Loans, FDI, Govt. Schemes

In short:
Enterprises need finance to **start, run, and grow**. Based on the duration, the finance may be raised from **short-term, medium-term, or long-term sources**.

Shares, Debentures, Types of Shares and Comparison between Shares & Debentures

1. Shares

Meaning:

A **share** is the smallest unit into which the capital of a company is divided. It represents **ownership** in the company. The holders of shares are called **shareholders**, and they are the real owners of the company.

Shares are a **long-term source of finance** for companies.

2. Types of Shares

Shares can be broadly classified into **Equity Shares** and **Preference Shares**.

A. Equity Shares (Ordinary Shares):

- Represent ownership in the company.
- Holders have **voting rights**.
- Dividend is **not fixed**; depends on profits.
- High risk but also potential for high returns.

- Residual claim: Paid last at the time of liquidation.

B. Preference Shares:

- Carry a **fixed rate of dividend**.
- Preference over equity shares in **payment of dividend** and **return of capital**.
- Generally **no voting rights** (except in special cases).
- Safer compared to equity shares but limited return.

Types of Preference Shares:

1. **Cumulative Preference Shares:** Unpaid dividends accumulate and are paid in future.
2. **Non-Cumulative Preference Shares:** Dividend lapses if not declared in a year.
3. **Convertible Preference Shares:** Can be converted into equity shares.
4. **Non-Convertible Preference Shares:** Cannot be converted.
5. **Redeemable Preference Shares:** Repaid after a fixed period.
6. **Irredeemable Preference Shares:** Not repayable during company's lifetime.

3. Debentures

Meaning:

A **debenture** is a **written acknowledgement of debt** issued by a company. It is a **long-term debt instrument** through which the company borrows funds from the public.

Debenture holders are **creditors** of the company, not owners. They get **fixed interest** at regular intervals, whether the company makes profit or not.

Types of Debentures:

1. **On the basis of Security:**
   - **Secured Debentures**: Backed by assets of the company.
   - **Unsecured (Naked) Debentures**: No security; higher risk.
2. **On the basis of Convertibility:**
   - **Convertible Debentures**: Can be converted into shares.
   - **Non-Convertible Debentures**: Cannot be converted.
3. **On the basis of Tenure:**
   - **Redeemable Debentures**: Repaid after fixed period.

- **Irredeemable Debentures**: Not repaid during lifetime; repaid on liquidation.

4. Comparison between Shares and Debentures

Basis	Shares (Equity & Preference)	Debentures
Meaning	Ownership in the company	Loan/debt given to the company
Holder's Status	Shareholders are owners	Debenture holders are creditors
Return	Dividend (not fixed, depends on profit)	Fixed interest (paid regularly)
Risk	High risk, high return	Low risk, fixed return
Voting Rights	Equity: Yes; Preference: Normally no	No voting rights
Repayment	Equity – at liquidation; Preference – preferential right	Repaid at maturity as per terms
Security	Not secured by assets	Can be secured/unsecured
Priority at Liquidation	Paid last (after debentures/creditors)	Paid before shareholders
Nature	Permanent capital (ownership finance)	Borrowed capital (loan finance)

5. Summary

- **Shares** represent **ownership** and provide dividends based on profits.
- **Debentures** represent **debt** and provide fixed interest irrespective of profits.
- Companies issue **shares to raise ownership capital** and **debentures to raise borrowed capital**.

Break-Even Analysis (BEA)

1. Meaning

Break-Even Analysis is the **process of determining the level of sales at which total revenue equals total cost**, i.e., the business neither makes profit nor incurs loss.

- The **point of no profit, no loss** is called the **Break-Even Point (BEP)**.

Formula (Units):

BEP (units)=Fixed CostsSelling Price per unit – Variable Cost per unit\text{BEP (units)} = \frac{\text{Fixed Costs}}{\text{Selling Price per unit – Variable Cost per unit}}BEP (units)=Selling Price per unit – Variable Cost per unitFixed Costs

Formula (Sales Value):

BEP (Sales ₹)=Fixed CostsContribution Ratio\text{BEP (Sales ₹)} = \frac{\text{Fixed Costs}}{\text{Contribution Ratio}} BEP (Sales ₹)=Contribution RatioFixed Costs

Where Contribution Ratio = Selling Price – Variable CostSelling Price\frac{\text{Selling Price – Variable Cost}}{\text{Selling Price}}Selling PriceSelling Price – Variable Cost

2. Importance / Objectives of Break-Even Analysis

1. **Decision Making:** Helps management decide the **minimum production level** to avoid loss.
2. **Profit Planning:** Determines sales required to achieve desired profit.
3. **Cost Control:** Highlights the impact of **fixed and variable costs** on profit.
4. **Pricing Decisions:** Assists in setting selling price to cover costs and earn profit.
5. **Investment Decisions:** Evaluates feasibility of projects before starting.
6. **Risk Analysis:** Helps assess **margin of safety** and financial risk.

Economic Order Quantity (EOQ)

1. Meaning

EOQ is the **optimum quantity of inventory** a company should order to **minimize total inventory cost**.

- Inventory costs include **ordering cost** (cost of placing order) and **holding/carrying cost** (cost of storing inventory).

2. EOQ Formula

EOQ=2×D×OCEOQ = \sqrt{\frac{2 \times D \times O}{C}}EOQ=C2×D×O

Where:

- D=Demand in units per yearD = \text{Demand in units per year}D=Demand in units per year
- O=Ordering cost per orderO = \text{Ordering cost per order}O=Ordering cost per order
- C=Holding cost per unit per yearC = \text{Holding cost per unit per year}C=Holding cost per unit per year

3. Numerical Example

Problem:

- Annual demand (D) = 10,000 units
- Ordering cost (O) = ₹50 per order
- Holding cost (C) = ₹2 per unit per year

Solution:

EOQ=2×10000×502=10000002=500000≈707 unitsEOQ = \sqrt{\frac{2 \times 10000 \times 50}{2}} = \sqrt{\frac{1000000}{2}} = \sqrt{500000} \approx 707 \text{ units}EOQ=22×10000×50=21000000=500000≈707 units

Interpretation:

- The company should order **707 units per order** to minimize total inventory cost.

4. Importance of EOQ

1. **Reduces Inventory Cost:** Balances ordering and holding costs.
2. **Prevents Stock-Out:** Ensures enough inventory is always available.
3. **Efficient Resource Use:** Reduces excess capital tied up in inventory.
4. **Better Planning:** Helps in production and procurement planning.

Summary Table:

Concept	Purpose / Importance	Key Formula
Break-Even Point (BEP)	Determine sales at which no profit/no loss occurs	BEP units = FC / (SP – VC)
EOQ	Find optimum order quantity to minimize inventory cost	EOQ = √(2DO/C)

Types of Capital

Capital refers to **funds invested in a business** to carry out its operations. Based on usage, capital is classified into **Fixed Capital** and **Working Capital**.

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1. Fixed Capital

Meaning:

- Fixed Capital is the **funds invested in long-term assets** of a business.

- These assets are used **over a long period** and are not meant for resale.

Examples:

- Land and buildings
- Machinery and equipment
- Furniture and fixtures
- Vehicles

Characteristics:

1. Long-term in nature.
2. Cannot be converted into cash quickly.
3. Required for the establishment and expansion of business.

2. Working Capital

Meaning:

- Working Capital is the **funds required for day-to-day operations** of the business.
- It is used to meet **short-term obligations** like paying salaries, purchasing raw materials, and other operating expenses.

Formula:

Working Capital=Current Assets–Current Liabilities\text{Working Capital} = \text{Current Assets} – \text{Current Liabilities}Working Capital=Current Assets–Current Liabilities

Examples:

- Cash in hand
- Accounts receivable (money owed by customers)
- Stock of raw materials and finished goods
- Short-term loans

Types of Working Capital:

1. **Positive Working Capital:** Current Assets > Current Liabilities → business can meet short-term obligations.
2. **Negative Working Capital:** Current Liabilities > Current Assets → may face liquidity problems.

3. Fixed Deposits (FD)

Meaning:

- Fixed Deposit is a **financial instrument offered by banks or financial institutions** where a sum of money is deposited for a **fixed period** at a **predetermined rate of interest**.

Features:

1. **Fixed tenure:** Money is locked for a certain period.
2. **Guaranteed interest:** Interest is paid at a fixed rate.
3. **Low risk:** Safer compared to stocks or mutual funds.
4. **Liquidity:** Can be withdrawn before maturity (with penalty).

Importance in Business:

- Provides a **safe avenue to park surplus funds**.
- Generates **steady income** from interest.
- Can be used as **collateral for loans**.

Summary Table

Type	Meaning	Examples	Key Points
Fixed Capital	Long-term funds invested in assets	Land, Machinery, Building	Long-term, non-liquid, essential for setup
Working Capital	Short-term funds for daily operations	Cash, Stock, Receivables	Liquid, ensures smooth operations
Fixed Deposits (FD)	Money deposited for fixed period at fixed interest	Bank FDs	Safe, low-risk, generates interest

In short:

- **Fixed Capital** → Assets for long-term use
- **Working Capital** → Funds for day-to-day operations
- **Fixed Deposit** → Safe investment option for surplus funds