Lecture Notes
Financial Mangement
BBA 403-18

MEANING OF FINANCIAL MANAGEMENT

Financial Management may be defined as Planning, Organizing, Directing and Controlling of financial activities in a business enterprise. More specifically it is concerned with optimal procurement and effective utilization of funds in a manner that the risk, cost and control considerations are properly balanced in a given situation. Financial management is concerned with efficient acquisition and allocation of funds. In operational terms, it is concerned with management of flow of funds and involves decisions relating to procurement of funds, investment of funds in long term and short term assets and distribution of earnings to owners. In other words, focus of financial management is to address three major financial decision areas namely, investment; financing; and dividend decisions.

Definition :

"The activity which is concerned with acquisition and utilization of all money/ Funds to be used in a corporate (Business) Enterprise." - Wheeler

More specifically, Financial Management is concerned with making the following four decisions:

1. Investment decision i.e., where and how much to invest in long-term assets and working capital? 2. Financing decision i.e., from where to raise funds?

3. Dividend decision i.e., how much earnings to be retained and how much to be distributed?

4. Liquidity decision i.e, how much cash in hand is to be maintained with the firm.

OBJECTIVE OF FINANCIAL MANAGEMENT

The objective of financial management is to maximize the current price of equity shares of the company. However, the current price of equity shares

should not be maximized by manipulating the share prices. Rather it should be maximized by making efficient decisions which are desirable for the growth of a company and are valued positively by the investors at large. A decision is considered efficient if it increases the price of share but is considered as inefficient if it results in decline in the share price. In other words, the objective of financial management is to maximize the wealth of the owners of the company, that is the shareholders. Here wealth maximization means the maximization of the market price of the equity shares of the company in the long run by making efficient decisions and not by manipulating the share prices. The financial manager must identify those avenues of investment; modes of financing, ways of handling various components of working capital which ultimately will lead to an increase in the price of equity share. If shareholders are gaining, it implies that all other claimants are also gaining because the equity share holders get paid only after the claims of all other claimants (such as creditors, employees, lenders) have been duly paid.

Objectives of financial management Primary objectives and Secondary objectives

1. Profit maximization.

1. To ensure availability if sufficient amount of funds at reasonable costs.

2. Wealth maximization.

3. To ensure optimum utilization of funds.

4.To ensure safety of funds through creation of reserves.

Nature and Scope of Financial Management :

Nature : 1. Management of flow of money.

Concept with application of skills in manipulation Use of Control of Money Determining financial needs and Raising of funds Utilization of funds Management of flow money : It refer to Inflow and outflow of money. Inflow of money means Entering of money in business from external source and outflow of money refers to consumption of money. Which gives us the Best output of financial Manager need to concentrate over the inflows as well as outflow of money so that there cannot be shortage and excursiveness of financial resources.

2 Concerns with application of skills in manipulation, we and control of money : In an effective financial Management, there is always a process of applying. Manager skills in Manipulate, utilization and control of money. In Financial Management, Controlling of firms financial resources play a vital role that is why a financial manager uses his skills in order to control such activities

3 Determining the Financial needs and Raising of Funds : In financial management, a financial manager, firstly determining the financial needs of an enterprise and then finding out the best suitable sources for raising them. The sources should be commensurate with needs of business. If the funds needed for longer period then long term sources of like share capital, debentures, etc can be raise for short term, period, the short term sources like. Trade Bill, Commercial paper can be.

4. Proper utilization of funds: Though raising funds is important but their effective utilization is also more important. The funds should be used in such a that maximum benefit is derived from them. The retires from their use should be more than their cost. It should be ensured that funds do not remain idle at my point of time. The funds committed to various operations should be effectively utilized. Those projects would be preferred which are beneficial to the business.

Scope of financial Management :

1. Estimating Financial Requirement

2. Deciding Capital Structure

3. Selecting a source of finance

4. Selecting a Pattern of investment

. 5. Proper Cash Management

6. Implementing Financial controls

7. Proper uses of surpluses.

1. Estimating Financial Requirements :

The first task of a financial manager is to estimate short-term and long-term financial requirements of his business. For this purpose, he will prepare a financial plan for present as well as for future. The amount required for

purchasing fixed assets as well as needs of funds for working capital will have to be ascertained

2. Deciding Capital Structure. The capital structure refers to the kind and proportion of different securities for raising funds. After deciding about the quantum of funds required it should be decided which type of securities should be raised. Long-term funds should be employed to finance working capital also, if not wholly then partially. A decision about various sources for funds should be linked to the cost of raising funds. If cost of raising funds is very high then such sources may not be useful for long.

3. Selecting a Source of Finance : After preparing a capital structure, an appropriate source of finance is selected. Various from which finance may be raised, include : share capital, debentures, financial institutions, commercial banks, public deposits, etc. If finances are needed for short periods then banks, public deposits and financial institutions may be appropriate, on the other hand, if long-term finances are required then share capital ad debentures may be useful.

4. Selecting a Pattern of Investment When funds have been procured then a decision about investment pattern is to be taken. The selection of an investment pattern is related to the use of funds. A decision will have to be taken as to which assets are to be purchased? The funds will have to be spent on fixed assets and then an appropriate portion will be retained for working capital.

5. Proper Cash Management : Cash management is also an important task of finance manager. He has to access various cash needs at different times and then make arrangements for arranging cash. Cash may be required to (a) purchase raw materials, (b) make payments to creditors, (c) meet wage bills, (d) meet day to day expenses. The usual sources of cash may be a: (a) cash sales, (b) collection of debts, (c) short term arrangements with bank etc. The cash management should be such that neither there is a shortage of it and nor it is idle. Any shortage of cash will damage the creditworthiness of the enterprise.

6. Implementing Financial Controls: An efficient system of financial Management necessitates the use of various control devices. Financial control devices generally used are : (a) Return on investment, (b) Budgetary Control, (c), Break Even Analysis, (d) Cost Control, (e) Ratio Analysis (f) Cost of Internal Audit return on investment is the best control device to evaluate the

performance of various financial policies the higher this percentage, better may be the financial performance.

7. Proper Use of Surpluses. The utilization of profits or surpluses is also an important factor in financial management. A effective use of surplus is essential for expansion and diversification plans and also in protecting the interests of shareholders.

3. Finance Function : Finance function is the most important of all business function. It remains a focus of all the activities it is possible to substitute or eliminate this function because the business will close down in the absence of finance.

Approaches to finance functions –

1. **Traditional approaches** – According to this approach the finance function was conformed only procurement of funds needed by business on most suitable firms. The utilization of funds was considered beyond the purview of finance function Here, it was felt that decision regarding application of funds are taken same where. Limitations : a. If completely ignore the decision making to the proper utilization of funds. b. If ignores the important issue of working capital finance and management. c. If ignore issue of allocation of funds. d. If ignore day to day financial problem of organization.

2.**Modern Approach** : It used in broader firms. It includes both raising and utilisation of funds. The finance function does not stop only by finding out sources of raising enough funds, their proper utilization .

According to this approach, it cover financial planning, raising of funds. Allocation of funds and financial control etc. Aims of Finance Function 1. Acquiring sufficient funds. 2. Proper utilization of funds.

3. Increasing profitability

4. Maximizes firms value.

1. Acquiring Sufficient Funds : The main aim of finance function is to assess the financial needs of an enterprise and then finding out suitable sources for raising them. If funds are needed for longer periods then long-term sources like share capital, debentures, term loans may be explored.

2. Proper Utilization of Funds : Though raising of funds is important but their effective utilization is more important. The funds should be used in such a way that maximum benefit is derived from them.

The planning and control of finance function aims at increasing profitability of the concern. It is true that money generates money. To increase profitability, sufficient funds will have to nor wastes more funds than required.

4. Maximizing Firm's Value : Finance function also aims at maximizing the value of the firm. It is generally said that a concern's value is linked with its profitability. Besides profit, the type of sources used for raising funds, the cost of funds, the condition of money market, the demand for products are some other considerations which also influence a firm's value.

5. **Sources of Financial information**

1. Banks

2. Financial institution

3. Government agencies

4. Investors

5. Brokers

6. Media

7. Supplier.

5. Functional Areas Financial Management

: 1. Determining financial needs .

2. Selecting the sources of funds.

3. Financial analysis and interpretation

4. Cost volume and profit analysis.

5. Capital Budgeting.

6. Working Capital management

7. Profit Planning and Control.

8. Dividend Policy.

1. Determining financial needs:

A finance manager is supposed to meet financial needs of the enterprise. For this purpose, he should determine financial needs of the concern. Funds are needed to meet promotional expenses, fixed and working capital needs.

2. Selecting the Source of Funds: A number of sources may be available for raising funds a concern may resort to issue of share capital and debentures. Financial institutions may be requested to provide long term funds. A finance manager has to be very careful and cautious in approaching different sources. The terms and conditions of banks may not be favourable to the concern.

3. Financial Analysis and Interpretation: The analysis and interpretation of financial statements is an important task of a fiancé manager. He is expected to know about the profitability, liquidity position, short term and long-term financial position of the concern. For this purpose, a number of ratios have to be calculated. The interpretation of various ratios is also essential to reach certain conclusions. Financial analysis and interpretation has become an important area of financial management.

4. Cost –Volume –Profit Analysis : Cost-volume-profit analysis is an important tool of profit planning. The costs may be subdivided as : fixed costs, variable costs and semi-variable costs. Fixed costs remain constant irrespective of changes in production. An increase or decrease in volume of production will not influence fixed costs. Variable costs, on the other hand, vary in direct proportion to change in production. Semi-variable remain constant for a period and then become variable for a short period.

5. Capital Budgeting : Capital budgeting is the process of making investment decisions in capital expenditures. It is an expenditure the benefits of which are expected to be received over a period of time exceeding one year. Capital budgeting decisions are vital to any organization. An unsound investment decision may prove to be fatal for the very existence of the concern.

6. Working Capital Management : Working capital is the life blood and nerve center of business. Just as circulation of blood is essential in the human body for maintaining life, Working capital is essential to maintain the smooth running of business. No business can run successfully without an adequate amount of working capital. Working capital refers to that part of the firm's capital which is

required for financing short term or current assets such as cash, receivables and inventories. It is essential to maintain a proper level of these assets.

7. Profit Planning and Control : Profit planning and control is an important responsibilities of the financial manager. Profit maximization is, generally, considered to be an important objective of a business. Profit is also used as a tool for evaluating the performance of management. Profit is determined by the volume of revenue and expenditure.

8. Dividend Policy : Dividend is the reward of the shareholders for investments made by them in the share of the company. Their investors are interested in earning the maximum return on their investment whereas management wants to retain profits for further financing. The company should distribute a reasonable amount as dividends to its members and retain the rest for its growth and survival.

FINANCIAL PLANNING MEANING OF FINANCIAL PLANNING

Financing Planning means deciding in advance the requirements as well as sources of funds. Financial Planning is process of estimating the fund requirements of a business and determining the sources of funds. Thus, there are two aspects of financial planning:

1. How much funds are required to finance (a) current assets (b) Fixed assets and (c) Future expansion project.

2. From where to raise these funds? (a) Whether funds to be raised through Owners' Funds (equity) or Borrowed Funds (Debt); (b) How much funds to be raised through Owners' Funds (equity) – Equity share, Preference Shares; reserves & Surplus. (c) How much funds to be raised through Borrowed Funds (Debt) – Debentures, Long-term loans. The aforesaid decisions should be taken keeping in mind three factors viz. Cost, risk and control. There should be a proper mix of various sources in such a manner that the funds are procured at optimum cost with the least risk and the least dilution of control of the present owners. . Financial planning takes into consideration the growth, performance, investments and requirements of funds for the business for a given period of time. The time horizon of financial planning is generally 3-5 years. Short-term financial plans called budgets are also drawn up\ to show the revenues and expenses relating to specific operation for a specific period of 1 year or less.

IMPORTANCE OF FINANCIAL PLANNING The importance of financial planning in financial management arises from the following benefit which flow from it:

1. It provides policies and procedures which make possible a closer cooperation between various functions of the business enterprise.

2. It aids the company in preparing for the future.

3. It provides a detailed plan of action for reducing uncertainty and for the proper direction of individual and group efforts.

4. It avoids confusion and waste such as loss of time, goodwill and financial resources

5. It helps management to avoid waste resulting from complexity of operations.

6. It tends to relieve top management from detailed and time consuming process as the financial units are known to everyone. It communicates expectations to all concerned so that they are properly and implemented.

7. The success or failure of production and distribution functions of the business depends on the financial decision.

MEANING OF WORKING CAPITAL

Working Capital refers to funds required to be invested in the business for a short period usually upto one year. It is also known as short-term capital or circulating capital or working capital. Working capital is sometimes known as circulating capital or revolving capital because funds invested in current assets are continuously recovered through the realization of cash and again reinvested in current assets. Thus, the amount keeps on circulating or revolving from cash to current assets and back again to cash.

CONCEPTS / TYPES OF WORKING CAPITAL I)

On the basis of concept : a. Gross working capital: It refers to all the current assets taken together. b. Net working capital : It is the surplus of current assets over and above current liabilities.

(i) A positive net working capital occurs when current assets exceed current liabilities;

(ii) (ii) A negative net working capital occurs when current liabilities exceed current assets. A negative working capital implies -ve liquidity and the company is not likely to be able to payoff even its current liabilities & hence may considerably damage its reputation. A weak liquidity position is perceived as a threat to the solvency of the company II)

(iii) On the basis of time : a. Permanent capital: i. Regular Working capital: It is the working capital required to ensure circulation of inventories. ii. Reserve working capital: It is the excess amount over the requirement of regular working capital which may be provided for contingencies. b. Temporary working capital : i. Seasonal working capital: It is required to meet seasonal demands. ii. Special working capital: It is required to meet special occasion such as launching of extensive marketing campaign. Factors affecting working capital requirements

(iv) Nature of business: There are some business which require higher initial capital and lesser working capital whereas some business require lower initial capital and larger amounts of working capital.

(v) 2. Credit policy: Liberal credit policy will require higher and strict dividend policy will require low working capital. 3. Production cycle: If length of production cycle is big it will require larger working capital and vice versa.

(vi) 4. Seasonal operations: Larger amounts of working capital is required for seasonal products because they are produced once and sold throughout the year.

(vii) 5. Inventory policy : If firm wishes to maintain higher stock levels then higher working capital is required and if lesser amount of inventory levels are maintained, it will require lesser working capital.

(viii) 6. Business cycle fluctuations: During Boom, higher working capital is required and lesser working capital is required during depression.

(ix) 7. Working capital cycle : If the time gap between raw materials purchased and its conversion into cash is big large working capital is required by the firm and vice versa.