<u>Financial Management</u>

Meaning –

Financial Management means planning, organizing, directing and controlling the financial activities such as procurement and utilization of funds of the enterprise. It means applying general management principles to financial resources of the enterprise.

Financial management focuses on ratios, equities and debts. It is useful for portfolio management, distribution of dividend, capital raising, hedging and looking after fluctuations in foreign currency and product cycles.

Financial management is the process of planning funds, organizing available funds and controlling financial activities to achieve the goal of an organization. It includes three important decisions which are investment decisions, financing decision and dividend decision for a specified period of time. Investment decision includes working capital decision and capital budgeting decision. Financing decision involves identifying sources of financing, determining the duration and cost of financing and managing investment return.

Scope/Elements

1. Investment decisions includes investment in fixed assets (called as capital budgeting). Investment in current assets are also a part of investment decisions called as working capital decisions.
2. Financial decisions - They relate to the raising of finance from various resources which will depend upon decision on type of source, period of financing, cost of financing and the returns thereby.
3. Dividend decision - The finance manager has to take decision with regards to the net profit distribution. Net profits are generally divided into two:
    a. Dividend for shareholders- Dividend and the rate of it has to be decided.
    b. Retained profits- Amount of retained profits has to be finalized which will depend upon expansion and diversification plans of the enterprise.

Objectives of Financial Management

The financial management is generally concerned with procurement, allocation and control of financial resources of a concern. The objectives can be-

1. To ensure regular and adequate supply of funds to the concern.
2. To ensure adequate returns to the shareholders which will depend upon the earning capacity, market price of the share, expectations of the shareholders.
3. To ensure optimum funds utilization. Once the funds are procured, they should be utilized in maximum possible way at least cost.
4. To ensure safety on investment, i.e, funds should be invested in safe ventures so that adequate rate of return can be achieved.
5. To plan a sound capital structure-There should be sound and fair composition of capital so that a balance is maintained between debt and equity capital.

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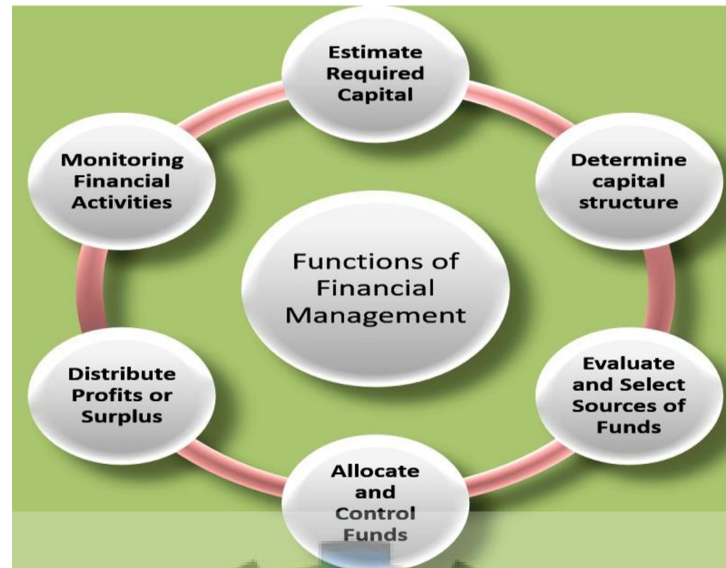
Functions of Financial Management



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1. **Estimation of capital requirements:** A finance manager has to make estimation with regards to capital requirements of the company. This will depend upon expected costs and profits and future programmes and policies of a concern. Estimations have to be made in an adequate manner which increases earning capacity of enterprise.
2. **Determination of capital composition:** Once the estimation have been made, the capital structure have to be decided. This involves short- term and long- term debt equity analysis. This will depend upon the proportion of equity capital a company is possessing and additional funds which have to be raised from outside parties.
3. **Choice of sources of funds:** For additional funds to be procured, a company has many choices like-
   a. Issue of shares and debentures
   b. Loans to be taken from banks and financial institutions
   c. Public deposits to be drawn like in form of bonds.

   Choice of factor will depend on relative merits and demerits of each source and period of financing.

4. **Investment of funds:** The finance manager has to decide to allocate funds into profitable ventures so that there is safety on investment and regular returns is possible.
5. **Disposal of surplus:** The net profits decision have to be made by the finance manager. This can be done in two ways:
   a. Dividend declaration - It includes identifying the rate of dividends and other benefits like bonus.
   b. Retained profits - The volume has to be decided which will depend upon expansional, innovational, diversification plans of the company.
6. **Management of cash:** Finance manager has to make decisions with regards to cash management. Cash is required for many purposes like payment of wages and salaries, payment of electricity and water bills, payment to creditors, meeting current liabilities, maintainance of enough stock, purchase of raw materials, etc.

7. **Financial controls:** The finance manager has not only to plan, procure and utilize the funds but he also has to exercise control over finances. This can be done through many techniques like ratio analysis, financial forecasting, cost and profit control, etc.

Importance of Financial Management:

The importance of financial management is vital to an organization. It is a pathway to attain goals and objectives. The financial manager measures organizational efficiency through proper allocation, acquisition, and management. It improves operational efficiency by providing a timely supply of fund. The following noticeable importance is found from financial management:

- Provides guidance in financial planning
- Assist in acquiring funds from different sources
- Helps in investing the appropriate amount of funds
- Increase organizational efficiency
- Reduces delay production
- Cut down financial costs
- Reduces cost of fund
- Ensures proper use of fund
- Helps business firm to take financial decisions
- Makes a guideline of earning maximum profits incurring minimum cost
- Increase shareholder's wealth
- Control the financial aspects of the business
- Provide information through financial reporting
- Makes the employees aware of saving funds.

Finance Functions -

Investment Decision

One of the most important finance functions is to intelligently allocate capital to long term assets. This activity is also known as capital budgeting. It is important to allocate capital in those long term assets so as to get maximum yield in future. Following are the two aspects of investment decision

a. Evaluation of new investment in terms of profitability
b. Comparison of cut off rate against new investment and prevailing investment.

Since the future is uncertain therefore there are difficulties in calculation of expected return. Along with uncertainty comes the risk factor which has to be taken into consideration. This risk factor plays a very significant role in calculating the expected return of the prospective investment. Therefore while considering investment proposal it is important to take into consideration both expected return and the risk involved.

Investment decision not only involves allocating capital to long term assets but also involves decisions of using funds which are obtained by selling those assets which become less profitable and less productive. It wise decisions to decompose depreciated assets which are not adding value and utilize those funds in securing other beneficial assets. An opportunity cost of capital needs to be calculating while dissolving such assets. The correct cut off rate is calculated by using this opportunity cost of the required rate of return (RRR)

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Financial Decision

Financial decision is yet another important function which a financial manger must perform. It is important to make wise decisions about when, where and how should a business acquire funds. Funds can be acquired through many ways and channels. Broadly speaking a correct ratio of an equity and debt has to be maintained. This mix of equity capital and debt is known as a firm's capital structure.

A firm tends to benefit most when the market value of a company's share maximizes this not only is a sign of growth for the firm but also maximizes shareholders wealth. On the other hand the use of debt affects the risk and return of a shareholder. It is more risky though it may increase the return on equity funds.

A sound financial structure is said to be one which aims at maximizing shareholders return with minimum risk. In such a scenario the market value of the firm will maximize and hence an optimum capital structure would be achieved. Other than equity and debt there are several other tools which are used in deciding a firm capital structure.

Dividend Decision

Earning profit or a positive return is a common aim of all the businesses. But the key function a financial manger performs in case of profitability is to decide whether to distribute all the profits to the shareholder or retain all the profits or distribute part of the profits to the shareholder and retain the other half in the business.

It's the financial manager's responsibility to decide a optimum dividend policy which maximizes the market value of the firm. Hence an optimum dividend payout ratio is calculated. It is a common practice to pay regular dividends in case of profitability Another way is to issue bonus shares to existing shareholders.

Liquidity Decision

It is very important to maintain a liquidity position of a firm to avoid insolvency. Firm's profitability, liquidity and risk all are associated with the investment in current assets. In order to maintain a tradeoff between profitability and liquidity it is important to invest sufficient funds in current assets. But since current assets do not earn anything for business therefore a proper calculation must be done before investing in current assets.

Types of Capital -

The term capital is used in economics in various senses. In ordinary language and sometimes in economics also capital is used in the sense of money.

But when we talk of capital as a factor of production, to confuse capital with money is quite wrong. Of course, money is used to purchase various factors such as raw materials, machinery, labour which help to produce goods, but money itself does not directly help in the production of goods.

The money which is available for investment and productive purposes has been called money capital or financial capital by some economists. But money capital is not the real capital. The real capital consists of machinery, tools, tube well, factories; tractors, etc., which directly assist in the production of goods.

Similarly, government securities and bonds, shares and debentures of public limited companies do not represent real capital. Securities, bonds, stocks, etc., possessed by individuals yield income to them but they cannot be called real capital because they represent only titles of ownership rather than factors of production.

Capital has been rightly defined as "produced means of production". This definition distinguishes capital from both land and labour because both land and labour are not produced factors. Land and labour are often considered as primary or original factors of production. But capital is not a primary or original factor; it is a produced factor of production. Capital has been produced by man by working with nature. Therefore, capital may well be defined as man-made instrument of production.

Capital thus consists of those physical goods which are produced for use in future production. Machines, tools and instruments, factories, canals, dams, transport equipment, stocks of raw materials are some of the examples of capital.

i) Fixed Capital

Fixed Capital refers to the capital investment made in the long term assets of the company. It is a compulsory requirement of a firm during its initial stage, i.e. to commence a business or to conduct the existing business. It is that part of the total capital, which is not used for production but they are kept in business for more than one accounting year. Its nature is almost permanent which exist in the form of tangible and intangible assets of the company.

The need of fixed capital in any business depends on its nature, i.e. manufacturing entities, railways, telecommunication, infrastructure companies requires high fixed capital as compared to the companies conducting wholesale and retail business. It is used for business promotion, expansion, modernization and so on.

As the fixed capital is invested in purchasing non-current assets like plant & machinery, land & building, furniture & fixtures, vehicles, patents, goodwill, trademark, copyright, etc. of the company, hence depreciation is charged on such assets due to a reduction in their value over time.

ii) Working Capital

Working Capital is the barometer that gauges financial soundness and operational efficiency of the company. It is the outcome of current assets less current liabilities, where current assets are those assets which can be converted into cash within one year, such as inventories, debtors, cash, etc. while current liabilities are the liabilities which falls due for payment within one year, i.e. creditors, tax provision, short term loans, bank overdraft, etc.

Working capital is used to finance day to day business operations. It determines the short-term solvency position of the company. It can be classified on the following basis:

- On the basis of time:
  - **Gross Working Capital**: Investment made in the current assets of the firm.
  - **Net Working Capital**: Deduction of current liabilities from current assets.
- On the basis of Concept:
  - **Permanent Working Capital**: It represents the hardcore business capital, i.e. the least investment needed in the working capital of the firm.
  - **Temporary Working Capital**: It is the fluctuating working capital. The working capital needed by the firm over and above the permanent or fixed working capital.

BASIS FOR COMPARISON	FIXED CAPITAL	WORKING CAPITAL
Meaning	Fixed capital refers to the investment of the enterprise in long term assets of the company.	Working capital means the capital invested in the current assets of the company.
Comprise of	Durable goods whose useful life is more than one accounting period.	Short term assets and liabilities
Liquidity	Comparatively illiquid.	Highly liquid.
Uses	Used to buy non-current assets for business.	Used for short term financing.
Serves	Strategic objectives	Operational objectives

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Components associated with WCM -

Often the interrelationships among the working capital components create real challenges for the financial managers. Inventory is purchased from suppliers, sale of which generates accounts receivable and collected in cash from customers to pay off those suppliers. Working capital has to be managed because the firm cannot always control how quickly the customers will buy, and once they have made purchases, exactly when they will pay. That is why; controlling the "cash-to-cash" cycle is paramount.

The different components of working capital management of any organization are:

• Cash and Cash equivalents

• Inventory

• Debtors / accounts receivables

• Creditors / accounts payable

A) Cash and Cash equivalents:

One of the most important working capital components to be managed by all organizations is cash and cash equivalents. Cash management helps in determining the optimal size of the firm's liquid asset balance. It indicates the appropriate types and amounts of short-term investments along with efficient ways of controlling collection and payout of cash. Good cash management implies the co-relation between maintaining adequate liquidity with minimum cash in bank. All companies strongly emphasize cash management as it is the key to maintain the firm's credit rating, minimize interest cost and avoid insolvency.

B) Management of inventories:

Inventories include raw material, WIP (work in progress) and finished goods. Where excessive stocks can place a heavy burden on the cash resources of a business, insufficient stocks can result in reduced sales, delays for customers etc. Inventory management involves the control of assets that are produced to be sold in the normal course of business.

For better stock/inventory control:

o Regularly review the effectiveness of existing purchase and inventory systems

o Keep a track of stocks for all major items of inventory

o Slow moving stock needs to be disposed as it becomes difficult to sell if kept for long

o Outsourcing should also be a part of the strategy where part of the production can be done through another manufacturer

o A close check needs to be kept on the security procedures as well

C) Management of receivables:

Receivables contribute to a significant portion of the current assets. For investments into receivables, there are certain costs (opportunity cost and time value) that any company has to bear, alongwith the risk of bad debts associated to it. It is, therefore necessary to have proper control and management of receivables which helps in taking sound investment decisions in debtors. Thereby, for effective receivables management one needs to have control of the credits and make sure clear credit practices are a part of the company policy, which is adopted by all others associated with the organization. One has to be vigilant enough when accepting new accounts, especially larger ones. Thereby, the principle lies in establishing appropriate credit limits for every customer and stick to them.

Effectively managing accounts receivables:

o Process and maintain records efficiently by regularly coordinating and communicating with credit managers' and treasury in-charges

o Prepare performance measurement reports

o Control accuracy and security of accounts receivable records.

o Captive finance subsidiary can be used to centralize accounts receivable functions and provide financing for company's sales

D) Management of accounts payable:

Creditors are a vital part of effective cash management and have to be managed carefully to enhance the cash position of the business. One has to keep in mind that purchasing initiates cash outflows and an undefined purchasing function can create liquidity problems for the company. The trade credit terms are to be defined by companies as they vary across industries and also among companies.

Factors to consider:

o Trade credit and the cost of alternative forms of short-term financing are to be defined

o The disbursement float which is the amount paid but not credited to the payers account needs to be controlled

o Inventory management system should be in place

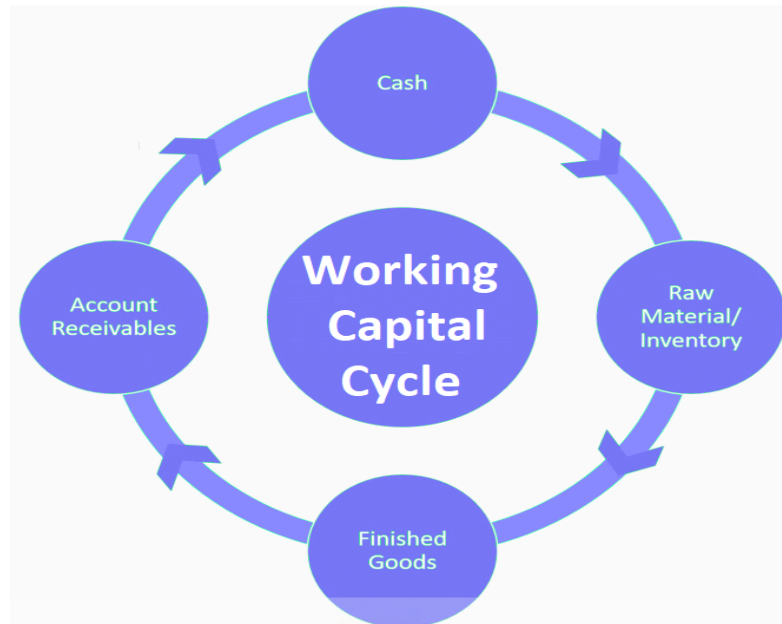
o Appropriate methods need to be adopted for customer-to-business payment through e-commerce

o Company has to centralize the financial function with regards to the number, size and location of vendors

Working capital cycle -

Working Capital cycle (WCC) refers to the time taken by an organization to convert its net current assets and current liabilities into cash. It reflects the ability and efficiency of the organization to manage its short-term liquidity position. In other words, the working capital cycle (calculated in days) is the time duration between buying goods to manufacture products and generation of cash revenue on selling the products. The shorter the working capital cycle, the faster the company is able to free up its cash stuck in working capital. If the working capital cycle is too long, then the capital gets locked in the operational cycle without earning any returns. Therefore, a business tries to shorten the working capital cycles to improve the short-term liquidity condition and increase their business efficiency.

The working capital cycle focuses on management of 4 key elements viz. cash, receivables (debtors), payables (creditors) and inventory (stock). A business needs to have complete control over these four items in order to have a fairly controlled and efficient working capital cycle. Let us look at an example to enable a better understanding of the concept of working capital cycle.



WORKING CAPITAL CYCLE EXAMPLE

Let us assume following details for a company that is in the manufacturing sector.

- A company takes raw materials on credit and has to pay back to its creditors in few days (say 30 days in our example). This is also called as average payables period which is can be calculated as the ratio of creditors to credit purchases.

  Average payable period = average creditors / credit purchases X 365.

  This means that the company enjoys a credit period of 30 days on the purchase of raw materials used for the production of the final good.
- The company takes "x" number of days to sell off its inventory; the "x" here is nothing but inventory turnover ratio converted into a number of days instead of the number of times. Assuming average inventory of $ 5000 and average sales of $ 18000, the inventory turnover ratio amounts to $ 5000 / $ 18000 X 365 = 102 days approximately.
- It takes some time for the company to convert its credit sales into cash due to the credit management policy incorporated by the company in terms of the credit period extended to customers. Assuming outstanding debtors of $ 9000 and a total credit sale amounting to $ 60,000 the average collection period can be calculated as

Average collection period = average debtors/ Total Credit Sales X 365

= $ 9000 / $ 60000 X 365

= 55 days approximately

Based on the above information, we infer that

- The company has to pay back its creditors within 30 days.
- For inventory to convert to sales, it takes roughly 102 days
- Conversion of receivables (debtors) to cash, on an average, takes 55 days

WORKING CAPITAL CYCLE CALCULATION

The working capital cycle for the company can be calculated as given below:

Working Capital Cycle = Inventory turnover in days + debtors turnover in days– creditors turnover

= 102 + 55 -30

= 127 days

This implies that the company has its cash locked in for a period of 127 days and would need funding from some source to let the operations continue as creditors need to be paid off in 30 days. Assuming the company had to make all cash payments for its raw material requirement, there wouldn’t be any creditors and the working capital cycle would then be 102 + 55 = 157 days.

Every company would like to keep its working capital cycle as short as possible. A shorter working capital cycle can be achieved by focusing on individual aspects of the working capital cycle.

A company can aim to shorten its working capital cycle by:

- Reducing the credit period given to its customers and thereby reducing the average collection period. Giving cash discount can also help improve the debtor’s turnover ratio or average collection period amid various other ways.
- The company can try to improve/streamline its process of manufacturing and focus on various ways to increase sales to reduce the time taken for inventory to convert to sales. The earlier the stock clearance better is the working capital cycle.
- A better negotiation to increase the credit period from suppliers of raw material and goods required for production can also aid reduction in the working capital cycle.

While the average collection period and credit period from suppliers aid in shortening the working capital cycle, the initial prime focus of the business should be to reduce the time taken for inventory to convert to sales. If the time taken is very long it could imply that the business is not able to generate sales for the goods produced and more and more capital gets locked in inventory. Either the business should try and reduce the time or should reduce the amount of inventory thereby reducing the amount locked in working capital. In other words, if the business is not able to reduce its working capital cycle and has higher inventory levels, it should aim at reducing inventory levels and reduce the amount locked in the working capital keeping the cycle time length same.

Most businesses cannot finance the operating cycle (average collection period + inventory turnover in days) with accounts payable financing alone. This shortfall can be managed by the business either out of profits accumulated over time, borrowed funds or by both. Let us look at the sources of funding which can be used to manage the gaps in working capital cycle

ASSIGNMENT QUESTIONS

1. Write down the meaning and definition of financial management.
2. What are the functions of financial management?
3. Why the financial management is essential for an organization?
4. Write down the different finance functions which helps the finance manager for the betterment of the company.
5. Write down the difference between fixed and working capital.
6. Write down the components of working capital in financial management.
7. What is a working capital cycle?