Class 12

Business Studies

Chapter 9_Focus Area 2022

Financial Management

Ajith Kanthi Wayanad

FINANCIAL MANAGEMENT

Finance refers to money, cash or fund available to carry out business operations

Finance is the life blood of business

A business enterprise requires funds at different stages - to start a business, to operate and to expand

FINANCIAL MANAGEMENT

Financial management is considered to be the management of finance function

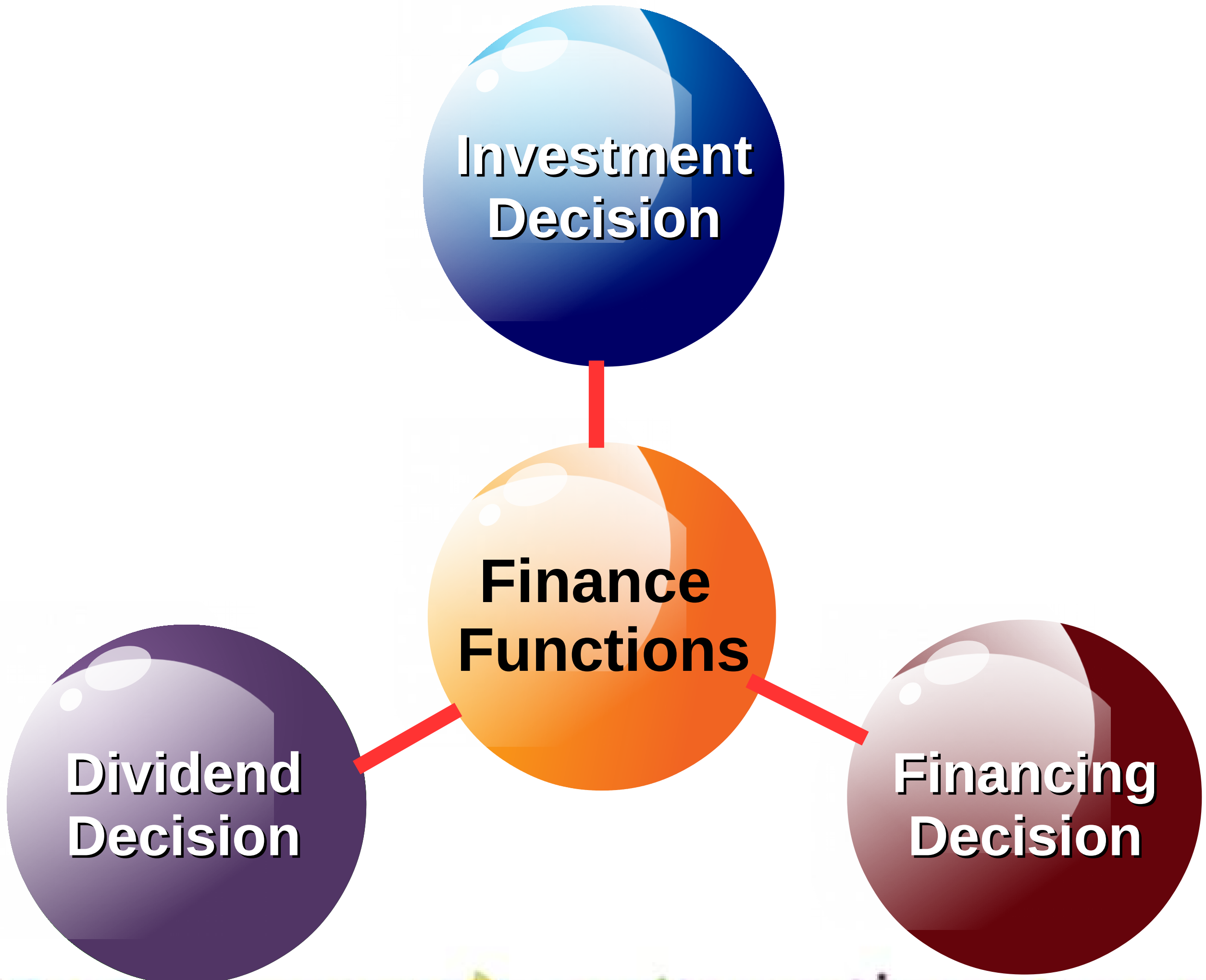
It deals with planning, organizing, directing and controlling financial activities like procurement and utilization of funds and distribution of earnings to owners

The financial management focuses on three major financial decision areas namely **investment, financing and dividend decisions**

They are collectively known as the finance functions of business

Finance Functions

(Financial Decisions)



Ajith Kanthi Wayanad

Investment Decision

Investment Decision

It is concerned with how firm's valuable funds are to be invested in various assets

Investment Decision

Long Term

Short Term

Investment Decision

a

Long term investment decisions
(capital budgeting decision)

E.g., Purchasing a new machine, opening a new branch etc.

Investment Decision

b

Short term investment decision (working capital decision)

Related to the day to day working of a business

E.g., Level of cash in hand, inventory etc.

Financing Decision

Financing Decision

It is concerned with the quantum of finance to be raised from various long term sources

They are shareholders' fund and borrowed fund such as shares, debentures, loans etc.

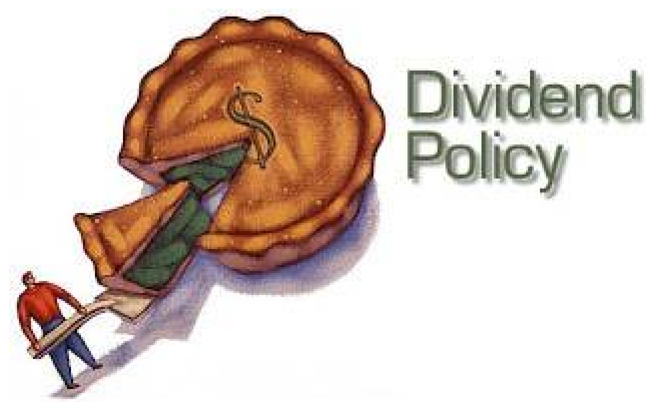
But a proper mix of the above securities is very much essential for maintaining a good capital structure of the company

Dividend Decision

Dividend Decision

It is concerned with the disposal of profits

A portion of the profit is to be retained in the business for growth and expansion. That part of profit is called **retained earnings** and the rest of the profit is to be distributed to the shareholders in the form of **dividends.**

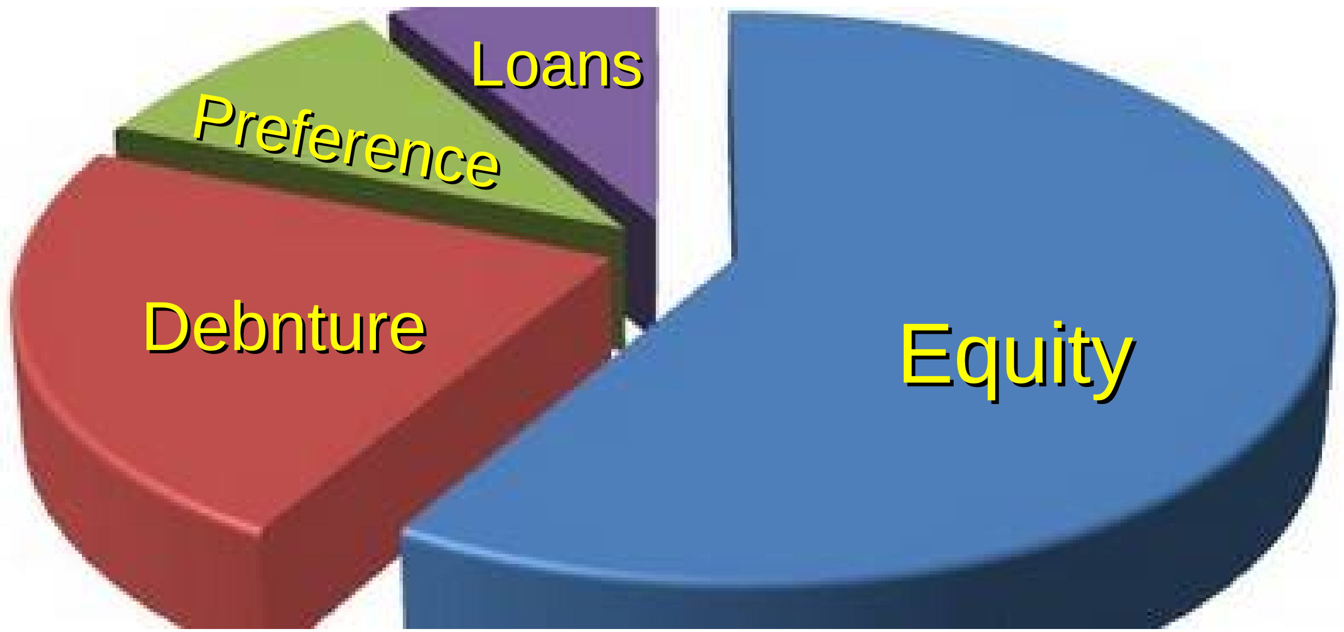


Here is the role of financial management that,
how much is to be retained and what would be distributed

Capital Structure

Capital Structure

Capital structure refers to the mix or composition of long term sources of funds such as equity share capital, preference share capital, debentures, long term loans and reserves and surplus

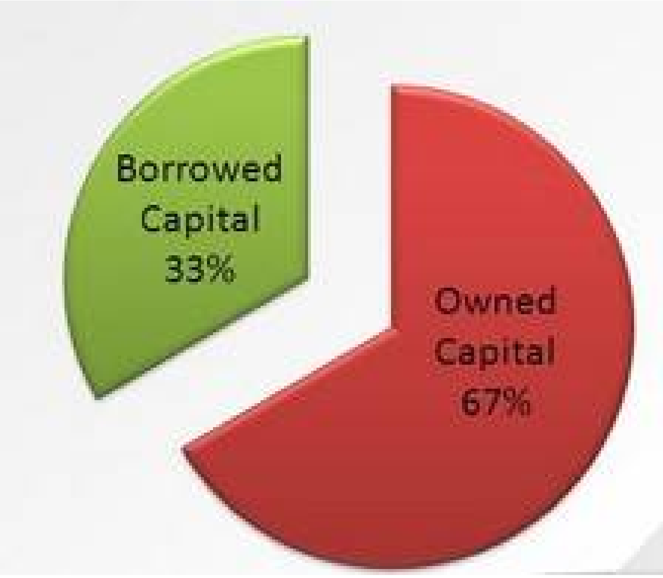


Capital Structure

It refers to the proportion of borrowed funds to owner's funds

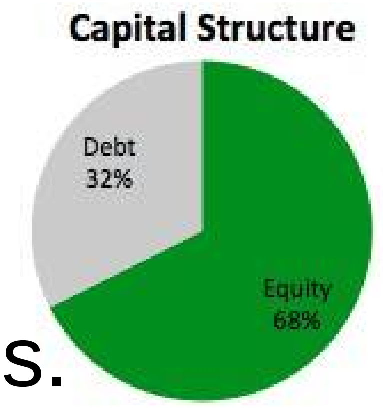
(It is a mix between owners' funds and borrowed funds)

Owners' funds are called **equity** and borrowed funds as **debt**



Capital Structure

The capital structure of a company consists any of the following forms:



1. Equity shares only.
2. Equity shares and preference shares.
3. Equity shares and debentures.
4. Equity shares, preference shares and debentures.
5. Equity, Preference, debentures and long term loans.

Factors Affecting the Choice of Capital Structure

Factors affecting Capital Structure

1 Cash flow ability for servicing the debt

Servicing debts means paying interest and principal amount of loans as and when it is due for payment

If a debt is to be included in the capital structure, the company should estimate the future cash flow to ensure the coverage

Factors affecting Capital Structure

2

Interest coverage ratio

ICR refers to the number of times, earnings before interest and taxes (EBIT) covers the interest obligation

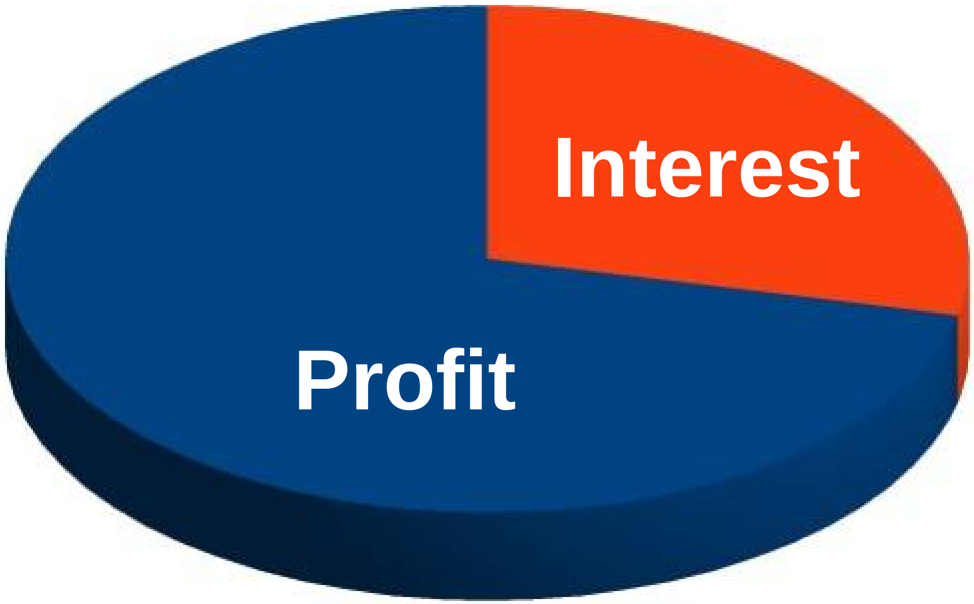
$$ICR = \frac{EBIT}{Interest}$$

Higher the ratio means lower the risk for the company to pay off interest in time

Factors affecting Capital Structure

3 Debt Service Coverage Ratio (DSCR)

The cash profits generated from the operations must be enough to service the debts and preference share capital



Factors affecting Capital Structure

4

Return on Investment (ROI)

If ROI is higher than rate of interest for debt, borrowed fund can be increased in capital structure, otherwise, increase in equity portion is good

Factors affecting Capital Structure

5

Cost of debt

If the firm is able to borrow at a lower rate, it may prefer more debt than equity in capital structure

Factors affecting Capital Structure

6

Tax rate

Income tax liability can be reduced by employing borrowed funds in capital structure, as the interest on debt is a deductible expense

Factors affecting Capital Structure

7

Cost of Equity

When a company increases debt in their capital structure, the financial risk faced by the equity shareholders may increase, consequently their desired rate of return may increase. So that the company cannot use debt beyond a point

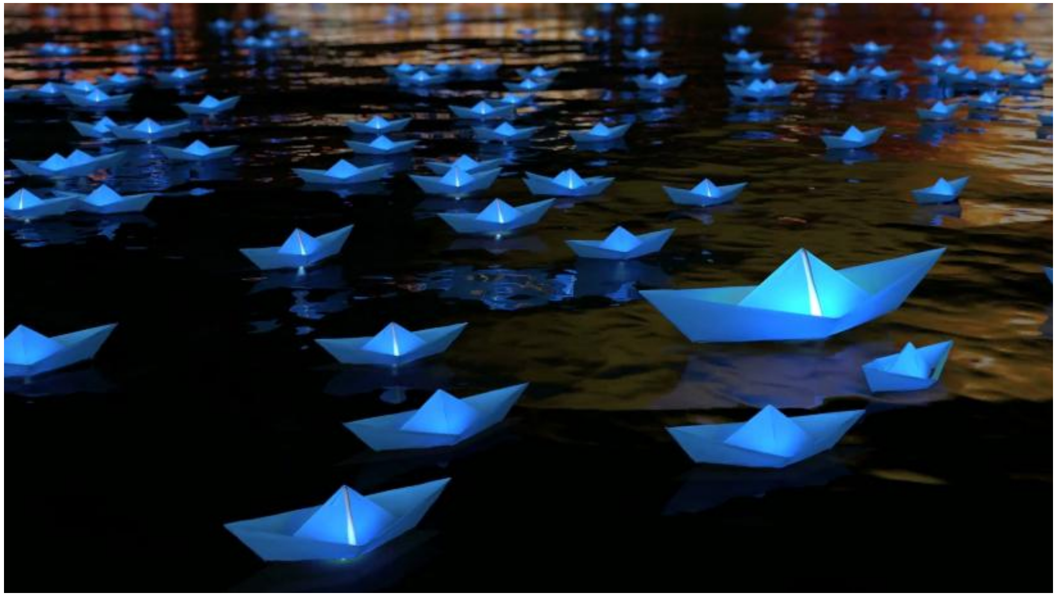
Factors affecting Capital Structure

8

Floatation cost

It is the cost incurred for floating (issue) securities such as brokerage, underwriting commission etc.

It is generally less in case of debts



Factors affecting Capital Structure

9

Risk Consideration

A business has two types of risks; they are financial risk (to pay interest, preference dividend, repayment of debt etc.) and business risk (operating risk).

It must be considered while choosing a suitable capital structure

Factors affecting Capital Structure

10

Flexibility

The capital structure should be capable of being adjusted according to the needs of changing conditions

To maintain flexibility, the company should maintain some borrowing power to take care of unforeseen circumstances

Factors affecting Capital Structure

11

Control

If the control of the management is to be retained, debt financing is recommended for raising additional fund

Factors affecting Capital Structure

12

Regulatory Framework

Rules and regulations framed by SEBI etc. must be considered while choosing a capital structure

Factors affecting Capital Structure

13

Stock Market Conditions

During depression in capital market, investors will prefer fixed interest bearing securities for safety and hence it is not advisable to issue shares that time

In a booming situation, issue of share will be more preferable

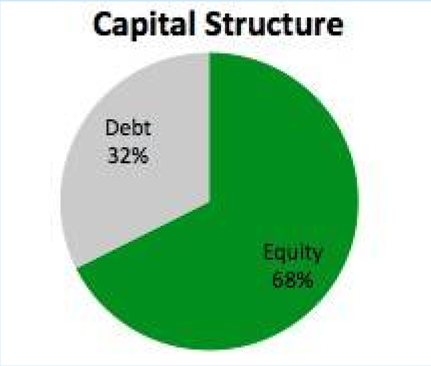
Factors affecting Capital Structure

14 Capital Structure of other Companies

Capital structure followed by other companies in the same industry may be adopted by considering whether they are in conformity with the industry norms or not

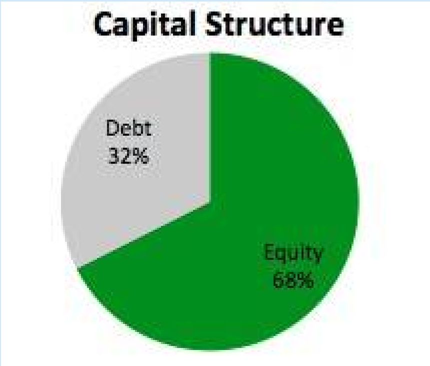
Factors affecting Capital Structure

1. Cash flow ability for servicing the debt
2. Interest coverage ratio
3. Debt Service Coverage Ratio (DSCR)
4. Return on Investment (ROI)
5. Cost of debt
6. Tax rate
7. Cost of Equity



Factors affecting Capital Structure

8. Floatation cost
9. Risk Consideration
10. Flexibility
11. Control
12. Regulatory Framework
13. Stock Market Conditions
14. Capital Structure of other Companies



Fixed Capital & Working Capital

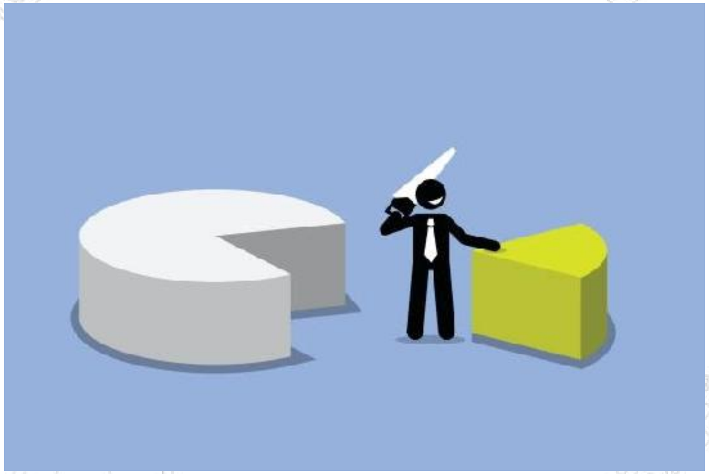
Fixed Capital

Fixed Capital

Fixed capital represents a long term investment which needed to acquire fixed assets like land and building, plant and machinery, vehicles etc., benefits of which are expected to be received over a number of years in future

Management of Fixed Capital

It refers to the allocation of firm's capital to different projects or assets which will have a long term implications in the business



Working Capital

Working Capital

Working capital is that part of capital required for investing in short term or current assets like inventory (raw materials, work in progress and finished goods), bills receivables, sundry debtors, cash required for day to day affairs like salaries, wages, rent, etc.

Working Capital

A business concern must neither have excessive nor inadequate working capital

Both the situations are dangerous

Working Capital

There are two concepts of defining working capital:

1. **Gross working capital**
   = Total investment in current assets

2. **Net working capital**
   = Current assets – Current Liabilities

Prepared by:

Ajith Kanthi @ Ajith P P
SKMJ HSS Kalpetta
Wayanad, Kerala
Ph: 9446162771, 7907712665
ajithkanthi@gmail.com


END
BEST ANIMATIONS