Financial Management Unit I

Finance Meaning:

MEANING OF FINANCE

- Finance may be defined as the art and science of managing money. It includes financial service and financial instruments.
- The concept of finance includes capital, funds, money, and amount. But each word is having unique meaning

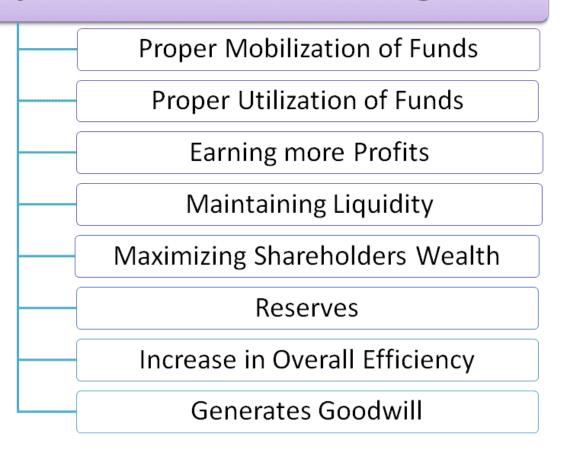
Meaning Of Financial Management

financial management

The planning, directing, monitoring, organizing, and controlling of the monetary resources of an organization.



Objectives of Financial Management



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Scope of Financial Management:

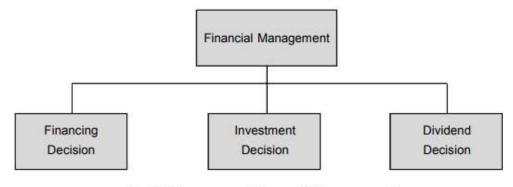
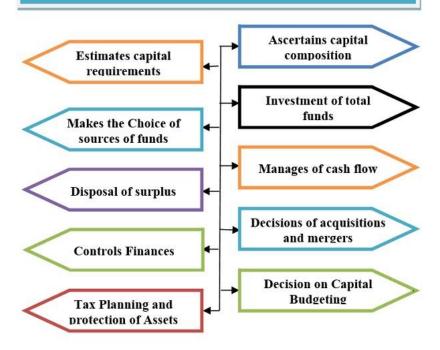
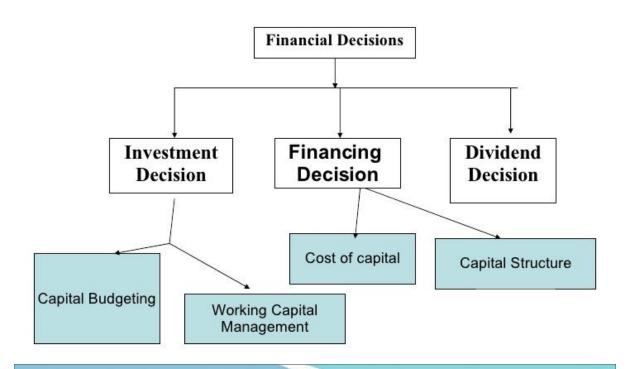


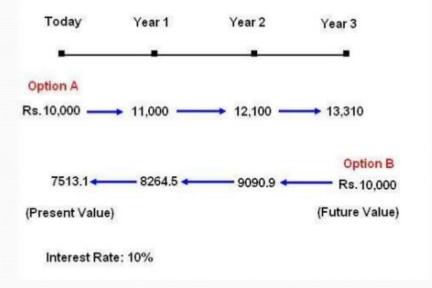
Fig. 1 - The scope of Financial Management

10 Major Functions of Financial Management









Factors That Affect Time Value of Money

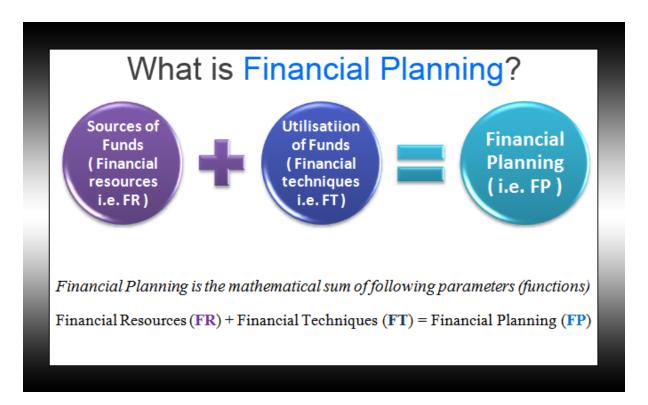
- Principal (p)-amount of the investment
 - ▶ Lump sum: Single quantity of money
 - ▶ Annuity: Stream of equal installments at equal time intervals
- Number of periods (n)
 - ▶ From the beginning of the investment until termination
- Interest rate (i)—annual percentage earned on investment
 - **▶** Simple interest
 - **▶** Compound interest



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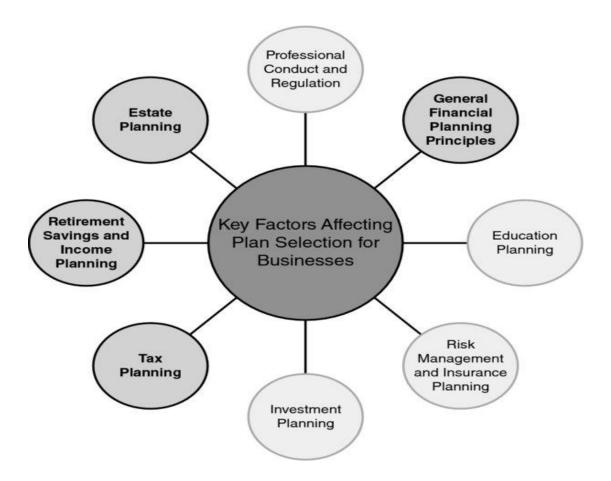
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Financial Planning Process





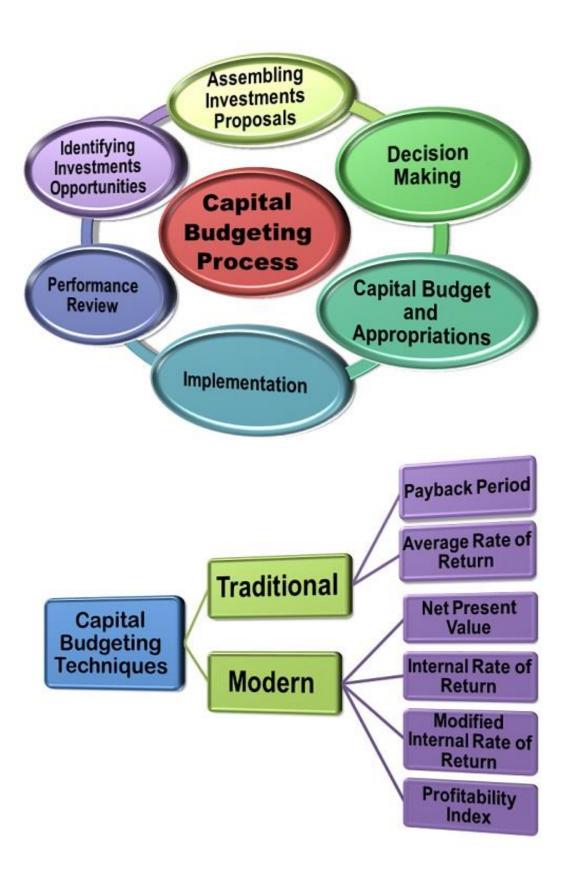
Unit II

Meaning of Capital Budgeting

Capital budgeting refers to budgeting of capital expenditure. In other words capital budgeting refers to the process of determining whether to or not to incur any capital expenditure. Capital expenditure refers to that expenditure the objective of which is to receive benefits over a number of years.

Example of Capital expenditure:

- Construction of factory building
- · Installation of a new machinery
- •Development of New product

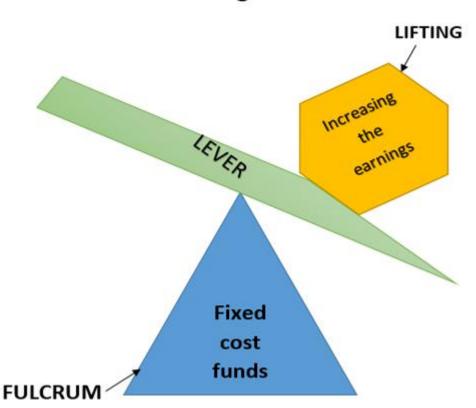


Unit III

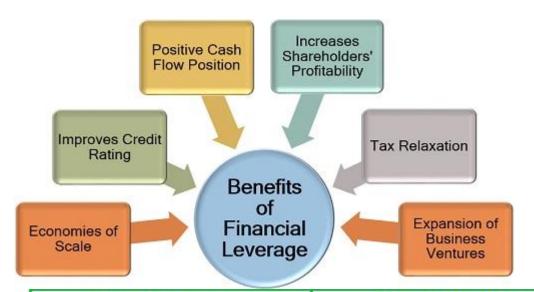
Meaning of Financial Leverage

- The use of the fixed-charges sources of funds, such as debt and preference capital along with the owners' equity in the capital structure, is described as <u>financial leverage</u> or <u>gearing or trading on equity.</u>
- The financial leverage employed by a company is intended to earn more return on the fixed-charge funds than their costs. The surplus (or deficit) will increase (or decrease) the return on the owners' equity. The rate of return on the owners' equity is levered above or below the rate of return on total assets.

Leverage in Finance



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Operating Leverage

- Operating leverage is associated with investment activities of the company.
- Operating leverage consists of fixed operating expenses of the company.
- It represents the ability to use fixed operating cost.
- 4. Operating leverage can be calculated by

$$OL = \frac{C}{OP}$$

- A percentage change in the profits resulting from a percentage change in the sales is called as degree of operating leverage.
- Trading on equity is not possible while the company is operating leverage.
- Operating leverage depends upon fixed cost and variable cost.
- Tax rate and interest rate will not affect the operating leverage.

Financial Leverage

- Financial leverage is associated with financing activities of the company.
- Financial leverage consists of operating profit of the company.
- It represents the relationship between EBIT and EPS.
- Financial leverage can be calculated by
 OP

$$FL = \frac{OP}{PBT}$$

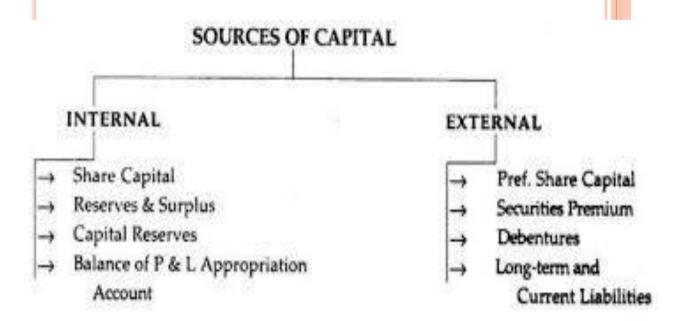
- A percentage change in taxable profit is the result of percentage change in EBIT.
- Trading on equity is possible only when the company uses financial leverage.
- Financial leverage depends upon the operating profits.
- Financial leverage will change due to tax rate and interest rate.

MEANING OF CAPITAL STRUCTURE



Capital structure refer to the proportion between the various long term source of finance in the total capital of firm

A financial manager choose that source of finance which include minimum risk as well as minimum cost of capital.



Features of Capital Structure

- ✓ Return
- ✓ Minimum Risk
- √ Simplicity
- √ Flexibility
- √ Capacity
- ✓ Control

Factors affecting capital structure

INTERNAL

- Financial leverage
- Risk
- Growth and stability
- Retaining control
- Cost of capital
- Cash flows
- Flexibility
- Purpose of finance
- Asset structure

EXTERNAL

- Size of the company
- Nature of the industry
- Investors
- Cost of inflation
- Legal requirements
- Period of finance
- Level of interest rate
- Level of business activity
- Availability of funds
- Taxation policy
- Level of stock prices
- Conditions of the capital market

THEORIES OF CAPITAL STRUCTURE

- Net Income (NI) Theory
- Net Operating Income (NOI) Theory
- Traditional Theory
- Modigliani-Miller (M-M) Theory

UNIT IV

Meaning of Cost of Capital

Cost of capital is the rate of return that a firm must earn on its project investments to maintain its market value and attract funds.

"Cost of capital is the rate of return the firm required from investment in order to increase the value of the firm in the market place".

"Cost of capital may be defined as the rate that must be earned on the net proceeds to provide the cost elements of the burden at the time they are due".

Cost of capital is "A cut-off rate for the allocation of capital to investment of projects. It is the rate of return on a project that will leave unchanged the market price of the stock".

TYPES OF COST OF C&PIT&L

1)COST OF EQUITY (Ke)

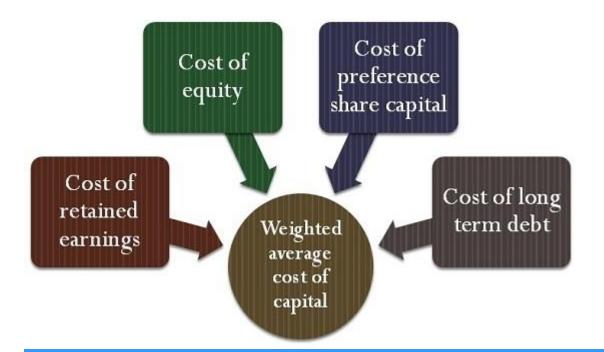
2)COST OF DEBT (Kd)

3)COST OF PREFRENCE SHARES (Kp)

4)COST OF RETAINED EARNINGS

What is 'Weighted Average Cost Of Capital - WACC'

- Weighted Average Cost Of Capital (WACC) is a calculation of a firm's cost of capital in which each category of capital is proportionately weighted.
- Weighted Average Cost Of Capital (WACC) is the rate that a company is expected to pay on average to all its security holders to finance its assets.

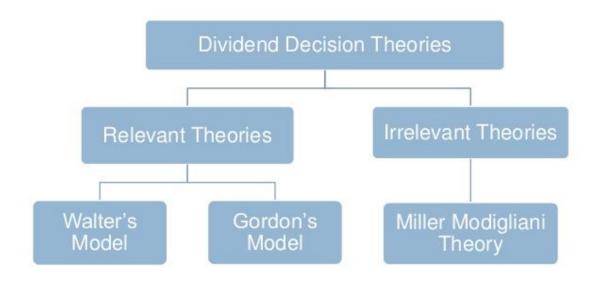


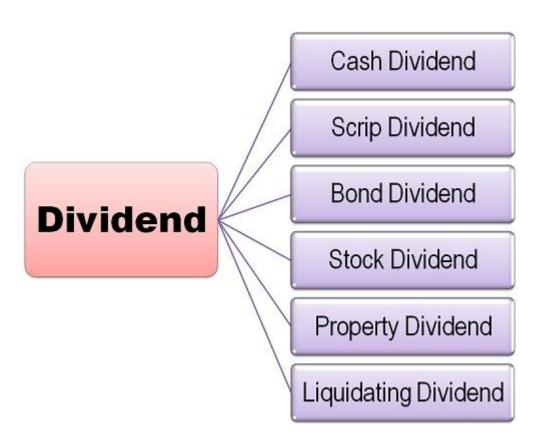
Chapter 7 Dividend Policy

Meaning of Dividend

Dividend refers to the business concerns net profits distributed among the shareholders. It may also be termed as the part of the profit of a business concern, which is distributed among its shareholders.

Types of Dividend Theories





FORMS OF DIVIDEND

(A) CASH DIVIDEND – A cash dividend is usual method of paying dividends. Payment of dividend in cash result in out flow of funds and reduces the company's net worth, though the shareholders get an opportunity to invest the cash in any manner they desire.

(B)SCRIP OR BOND DIVIDEND A scrip dividend promises to pay the shareholders at a future specific date. In case company does not have sufficient funds to pay dividends in cash, it may issue bonds for amount due to the shareholders.

(C)PROPERTY DIVIDEND – Property dividend are paid in the form of assets other than cash. It is distributed under the exceptional case and are not popular in India.

(4) STOCK DIVIDEND – Stock dividend means the issue of bonus shares to the existing shareholders.

*BONUS SHARES

Definition: Bonus shares are additional shares given to the current shareholders without any additional cost, based upon the number of shares that a shareholder owns. These are company's accumulated earnings which are not given out in the form of dividends, but are



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UNIT V

Working Capital Turnover

Working capital turnover measures the revenue generated from every investment made in the form of working capital. The working capital turnover ratio helps the company to acknowledge the relationship between the working capital invested in the company to fund the routine operations and amount of sales generated through these operations.

Advantages

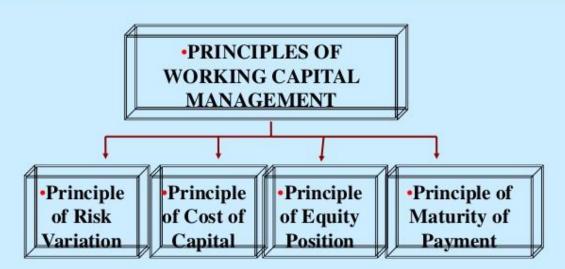
- It ensures smooth functioning of operations of the company.
- It eliminates the requirement of additional funds.
- It helps to ease business expansion.
- It gives a competitive edge over its peer.

Disadvantages

- Extremely higher ratio sometimes reflects that the company does not have enough capital to support its sales growth.
- Higher working capital turnover often leads to the insolvency of the business.

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Principles Of Working Capital Management



Need and importance of WC 1. Solvency of the business

- Goodwill
- Easy loans
- Cash discount
- Regular supply of raw material
- Regular payment of salaries, wages, etc.
- Exploitation of favourable market conditions
- Ability to meet crisis
- High morale
- 10. Quick and regular return on investment

DETERMINANTS OF WORKING CAPITAL

- Size Of Business
- ➤ Nature Of Business
 - >Storage Period
 - Credit Period
- ➤ Seasonal Requirement
- ➤ Potential Growth Or Expansion Of Business
 - ➤ Changes In Price Level
 - ➤ Dividend Policy
 - ➤ Working Capital Cycle
 - > Operating Efficiency
 - >OTHER FACTORS



Factoring - Meaning



- Is a financial service
- Institution called 'Factor' which -
- Undertakes the task of realizing 'receivables', i.e. accounts receivables, book debts, bills receivables &
- Also the 'Factor' manages the sales registers, sundry debts of the commercial firms/trading agents, for a commission.
- This activity is called 'Factoring'

