FINANCIAL MANAGEMENT
(Additional Lessons)

BBA (IV Semester Core Course)
B.Com (V Semester Specialisation-Finance)

2011 Admission onwards

UNIVERSITY OF CALICUT

SCHOOL OF DISTANCE EDUCATION

CALICUT UNIVERSITY.P.O., MALAPPURAM, KERALA, INDIA – 673 635

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STUDY MATERIAL

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B.Com (V Semester Specialisation- Finance)

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FINANCIAL MANAGEMENT (Additional lessons)

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CONTENTS

MODULE I	05
MODULE II	06
MODULE III	08
MODULE IV	13
MODULE V	15

MODULE I

Syllabus-*Financial Management: meaning, nature and scope of finance; financial goals: profit maximization, wealth maximization; finance functions,-investment, financing and dividend decisions.*

As per the study material Module I include scope and objective of financial management, it comprise meaning, nature, scope and objectives of financial management.

Finance was a branch of Economics till 1890. Economics is defined as study of the efficient use of scarce resources. The decisions made by business firm in production, marketing, finance and personal matters from the subject matters of economics. Finance is the process of conversion of accumulated funds to productive use. It is so intermingled with other economic forces that there is difficulty in appreciating the role plays.

Howard and Uptron in his book Introduction to Business Finance defined, "as that administrative area or set of administrative function in an organization which relate with the arrangement of cash and credit so that the organization may have the means to carry out its objectives as satisfactorily as possible."

In simple terms finance is defined as the activity concerned with the planning, raising, controlling and administrating of the funds used in the business. Thus, finance is the activity concerned with the raising and administrating of funds used in business. Financial management is the managerial activity concerned with the raising and administrating of funds used in business. So the nature and scope of financial management is same as that of finance.

Financial goals are the objectives of financial management. It includes the profit maximization and wealth maximization (Page-8).

Finance functions are the functions of financial management it includes Investment, Financing and Dividend decisions (Page-7).

MODULE II

Syllabus- *Capital budgeting: nature of investment decision; investment evaluation criteria-net present value, internal rate of return, profitability index, payback period, accounting rate of return, NPV and IRR comparison; capital rationing; risk analysis in capital budgeting.*

As per study material Module II includes Investment Decision. It comprises nature of investment decision (Page-12).Investment evaluation criteria (Page-13) such as net present value, internal rate of return, profitability index, payback period, accounting rate of return.

NPV and IRR comparison- it included in Page-21.In addition to that-

Similarities:

1. Both consider time value of money
2. Both lead to the same acceptance or rejection decision rule when there is a single project.

Differences

NPV	IRR
1. The minimum desired rate of return (cost of capital) is assumed to be known.	1. .The minimum desired rate of return(cost of capital)is to be determined.
2. It implies that the cash inflows are invested at the rate of firms cost of capital.	2. It implies that the cash inflows are invested at the IRR of the project.
3. It gives absolute return.	3.It gives percentage return
4.The NPV of different projects can be added	4.The IRR of different projects cannot be added

Capital Rationing implies the choice of investment proposals under financial constraints in terms of a given size of capital expenditure budget. The objective to select the combination of projects would be the maximization of the total NPV.The project selection under capital rationing involves two stages.

(i) Identification of the acceptable projects.
(ii) Selection of the combination of projects.

The acceptability of projects can be based either on profitability index or IRR.The method of selecting investment projects under capital rationing situation will depend upon whether the projects are indivisible or divisible. In case the project is to be accepted or rejected in its entirety, it is called an indivisible project; a divisible project on the other hand, can be accepted /rejected in part.

Example

A company has Rs.7 crore available for investment. It has evaluated its options and has found that only 4 investment projects given below has positive NPV.All these investment are divisible. Advice the management which investment(s) projects it should select.

Project	Initial investment (Rs.crore)	NPV (Rs.Crore)	PI
X	3.00	0.60	1.20
Y	2.00	0.50	1.25
Z	2.50	1.50	1.60
W	6.00	1.80	1.30

Solution

Ranking the projects in Descending Order of Profitability Index

Project	Initial investment (Rs.crore)	PI	NPV (Rs.Crore)
Z (1)	2.50	1.60	1.50
W (2)	6.00	1.30	1.80
Y (3)	2.00	1.25	0.50
X (4)	3.00	1.20	0.60

Accept project Z in full and W in Part as it will maximize the NPV.

Example

A company has Rs.70 crore available for investment. It has evaluated its options and has found that only 5 investment projects given below with NPV.All these investments are indivisibles well as independent. Advice the management which investment(s) projects it should select.

Project	Initial investment (Rs.crore)	NPV (Rs.Crore)
A	10	6
B	24	18
C	32	20
D	22	30
E	18	20

Solution

NPV from investments D,E and B is Rs 68 crore with Rs.64 crore utilized leaving Rs 6 crore to be invested in some other investment outlet. No other investment package would yield an NPV higher than this amount. The company is advised to invest in D, E and B projects.

MODULE III

Syllabus- Working capital: meaning,significance and types of working capital, Financing of working capital, Source of working capital; management of inventory; management of cash; management of account receivables; optimum credit policy; credit collection; factoring service; various committee reports on bank finance; dimensions of working capital management.

As per study material Module V include Working Capital Management. Meaning, significance and types of working capital (Page-65).Financing of working capital (Page-76).Sources of working capital (Page-33) in addition to that-

Sources of working capital

There are basically two sources available for working capital -internal sources and external sources. If the size of the business is large, the fund requirement will have to be financed from external sources. The working capital requirements of the business can be met by trade credit, loan from commercial banks, account receivable financing etc. These are short term sources. Medium term sources include hire purchase, lease financing, public deposits, term loans, central government subsidy etc. The long term sources include equity shares, preference shares, debt, term loans from financial institutions. Long term sources are used for financing the capital cost of the business. Thus it is better to raise capital from two or more sources. The technique of raising capital from multiple sources is known as *layered financing*.

Capital may be classified on the basis of the length of the period for which capital is required- short term capital, medium term capital and long term capital. Capital required for a period not exceeding 12 months is termed as short term capital. It is required for variable working capital. Capital required for the period ranging from one to 5 years is called medium term capital. Initial working capital and permanent working capital may be financed through medium term capital. Capital required for the period exceeding 5 years is called long term capital. Fixed capital is financed by long term capital.

The following chart shows the various sources of project finance:

A. Sources of long term fund (To finance fixed capital requirements)

1. Issue of shares
2. Issue of debentures
3. Term loans from specialized financial institutions like IFCI, IBRD etc.
4. Venture capital

B. Sources of raising medium term funds (To finance fixed working capital requirements)

1. Public deposits
2. Deferred credit
3. Lease Finance
4. Subsidy and other incentives / assistance from the government
5. Hire purchase

C. Methods of raising short term funds (to finance working capital requirements)

1. Trade credit (credit allowed by one businessman to other businessmen, e.g., credit purchases)
2. Commercial banks (bank overdraft and cash credit)
3. Accounts receivable

Public Deposits

A company can raise deposits to meet its capital needs directly from the public at an interest rate generally above the bank rate. These public deposits represent unsecured borrowings from the public at large for a period varying between 2-3 years. As per Companies Acceptance Deposit Rules 1975, public deposits can be raised only up to 25% of the paid up capital and free reserves of the company.

This source is useful due to the following reasons: (i) These are cheaper, (ii) These are unsecured, (iii) Involves only lesser paper formalities, and (iv) This does not involve monitoring from the outside agencies.

Deferred Credit

Under this arrangement payments to suppliers of plant and equipments are made in agreed installments over a specified period of time at some agreed rate of interest on the outstanding balance. Normally the suppliers offering deferred credit facility ask for bank guarantee from the buyer. Banks will examine the viability of the project before giving guarantee for such deferred credits.

Incentive Sources

The government and its agencies may provide financial support as incentives to certain types of promoters or for setting up industrial units in certain locations. These incentives may take the form of seed capital assistance (provided at a nominal rate of interest to enable the promoter to meet his contribution to the project), or capital subsidy (to attract industries to certain locations), or tax exemption (particularly from sales tax) for a certain period.

Lease Financing

Lease financing is one of the methods of long term financing. Lease is a right to use an asset. In a lease deal the owner allows the user to use the asset for a specified period for a consideration. Thus lease financing can be explained as a contract between the owner of the asset and the user of the asset whereby the owner of the asset gives it to the user for a consideration. The owner of the asset is called the *lessor* (i.e. the leasing company) and the user of the asset is called the *lessee* (i.e. the business enterprise which hires the assets). The consideration (periodic payment) which is required to be paid by the lessee for using the asset (or for taking the asset for lease) is called lease rental. Instead of acquiring the assets, a business enterprise enters into an agreement with the leasing company whereby the leasing company (lessor) purchases the asset required by the business enterprise and then leases the asset on a long term basis to the business enterprise (lessee). The lessor retains the title to the asset and he can sell the asset after the lease period. Thus under lease financing, no initial funds are required, but the lessee has to make a regular lease payment. If the lease is not renewed, the lessor takes the possession of the asset after the expiry of the existing lease period.

Institutional Finance

There are several financial institutions for giving financial assistance to entrepreneurs. Some of them are IDBI, IFCI, SIDBI, NABARD etc

Management of inventory (Page-77), management of cash (Page-80) ,management of account receivables (Page-81),optimum credit policy, credit collection (Page-82)in addition to that-

Optimum credit policy:-

A firm should establish receivables policies after carefully considering both benefits and costs of credit standards, credit terms, and collection procedures.

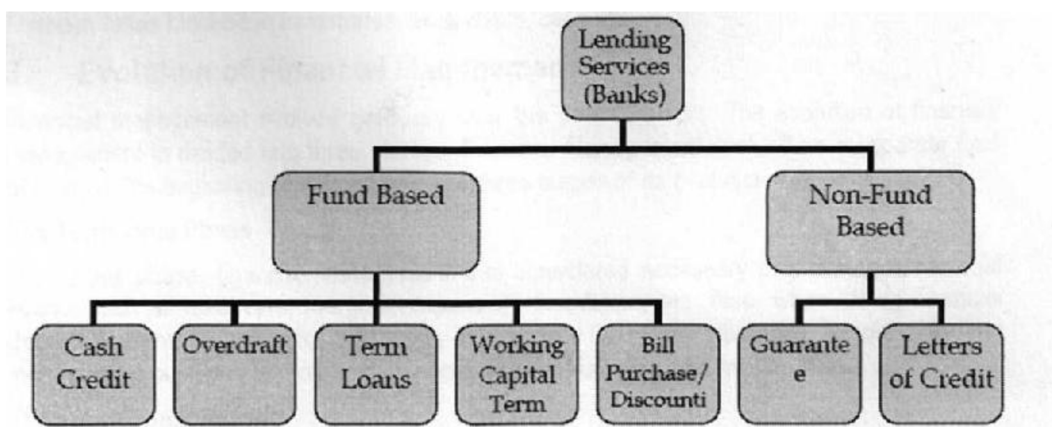
Credit collection:-

Credit collection refers to the procedure followed to collect the receipts when they become due. The collection policies may be classified in to (i) strict and (ii) liberal .The effect of tightening the collection policy would be (i) decline the debt (ii) decline in collection period resulting lower interest cost (iii) increase in collection cost and (iv) decline in sales. The effect of a lenient policy would be exactly the opposite.

Factoring service included in (Page-77).

FUNDING FROM BANKS

Banks play an important role in funding of the business enterprises. Apart from supporting businesses in their routine activities (deposits, payments etc) they play an important role in meeting the long term and short term needs of a business enterprise. Different lending services provided by Commercial Banks are depicted as follows:-



VARIOUS COMMITTEES ON BANK FINANCE IN INDIA

Year	Chairman	Issue covered
1929	B N Mitra	Central Banking Functions and Agr. Finance
1944	DR Gadgil	Agricultural finance
1945	RS Saria	Agr Finance & Coop Societies
1949	Sri Purshottam Dass	Agr Finance & Coop Societies
1954	AD Gorwala	Study of rural finance
1968	Dehejia	Financial requirement of trade & industry
1970	Chatalier	Finance to small scale industry
1970	BD Thakar	Job criteria approach in bank loans
1971	RK Talwar	Enactments at state level regarding agriculture finance
1974	P.L.Tandon	Maximum Permissible Bank Finance (MPBF)
1975	Varshney	Revised method for loans of Rs.2 lac or more
1976	CE Kamathv	Multi-institutional approach in Agr finance
1978	Baldev Singh	Simplification of loan procedures and documentation relating to agricultural and allied activities
1978	Tambe	Composite term loan to SSIs
1979	Chore committee	Cash credit system of banks
1980	K S Krishaswami	Role of banks in priority sector advances and 20 point programmes
1982	Puri	Uniformity of loan application
1983	Tiwari	Indl sickness and rehabilitation of sick units
1989	SC Kalyansundaram	Introduction of factoring services
1991	M Narasimha	Financial sector reforms
1992	S.S.Marathe	Urban co-operative banks
1992	AC Shah	NBFCs
1992	Nadkarni SS	Trading in public sector bonds
1993	PR Nayak	Institutional credit to SS SSIs
1993	Jilani R	Credit delivery system
1998	M Narsimham	Financial Sector reforms
1998	S L Kapoor	Institutional credit to SSIs
1998	R H Khan	Harmonization of role of FIs & Banks
1998	L C Gupta	Financial derivatives

Important recommendation and directives have stemmed from the following groups

I. Dehejia Committee

(1)Borrower must decide how much would borrow from bank.

(2)Bank credit should be treated as first source of finance

(3)Amount of credit extended is based on amount of securities.

II. Tandon committee

(1) Norms of current asset.
(2) Maximum permissible bank finance.
(3) Emphasis on loan system.
(4) Periodic information and reporting system.

III. Chore committee

(1) The banks should obtain quarterly statements from borrowers.
(2) Periodical review of loan
(3) Separate credit limits for peak and non peak level.
(4) Bank should discourage sanction of temporary limits.

Dimensions of working capital management.

Working capital management is three dimensional in nature, such as-

1. Profitability, Risk, Liquidity.
2. Composition and level of Current Asset.
3. Composition and level of Current Liabilities

Working capital management is concerned with the problems that arise in managing the current asset (CA) current liability (CL).There are two concept of working capital: Gross and Net. The Gross Working Capital (GWC) means total CA.The Net Working Capital (NWC) is the difference between the CA and CL.The NWC has a bearing on liquidity, profitability and risk. The greater is the NWC, the higher is the liquidity, and the lower is the risk and the profitability, and vice-versa.

MODULE IV

Syllabus*-Capital structure theories: traditional and MM hypotheses; determing capital structure in practice; Capital structure planning. Cost of capital: meaning and significance of cost of capital; calculation of cost of debt, preference capital, equity capital and retained earnings; operating and financial leverage; measurement of leverages; effects of operating and financial leverages on profit.*

As per study material Module III include Financing Decision, it comprises, capital structure theories-traditional and MM hypotheses (Pages-38-42).

Example:

Companies U and L are identical in every respect, except that U is unlevered while L is levered. Company L has Rs.20 lakh of 8% debentures outstanding. Assume-

(1) that all the MM assumptions are met.
(2) that the tax rate is 35%
(3) that EBIT is Rs. 6 lakh and that equity-capitalization rate for company U is 10%.

(a)What would be the value for each firm according to the MM Approach?

(b)Suppose v_u=Rs.2500000 and v_l=Rs.3500000.According to MM do they represent equilibrium values? If not, explain the process by which equilibrium will be restored.

Solution:

a) $$V_u = \frac{EBIT(1-t)}{K_e} = \frac{Rs\ 6,00,000\ (1-0.35)}{0.10} = Rs\ 39,00,000$$

V_l=V_u+Bt=Rs.39,00,000+RS.20,00,000 (0.35)=Rs.46,00,000

(b) Firm U is undervalued and firm L is overvalued. Investors will be better off by investing in the undervalued firm as they will require lower investment cost to earn the same income as they earn in the overvalued firm, Therefore, they will sell their holdings of the overvalued firm (L) and buy shares of the undervalued firm (U).As a result, the price of shares of company L will come down while that of company U will rise. This process will continue until equilibrium in the values is restored.

Capital structure policies in practice:

- Indian corporate employ substantial amount of debt in their capital structure in terms of the debt –equity ratio as well as total debt to total asset ratio.Nonetheless, the foreign controlled companies in India use less debt than the domestic companies. The dependence of the Indian corporate sector on debt as a source of finance has over the years declined.
- Indian enterprises seem to prefer long-term borrowings over short-term borrowings.
- As a result of debt –dominated capital structure, the Indian corporate are exposed to a very high degree of total risk .The foreign controlled companies, however, are exposed to lower overall risk as well as financial risk.
- Retained earnings are the most favored source of finance. Loan, Hybrid securities are other source of finance used in India.

Capital structure Planning: - (page-38)

The term capital structure planning otherwise known as designing capital structure, capital structure decision, factors determining capital structure etc.

The key factors governing the capital structure are-

(1)Minimization of risk-it includes the profitability and liquidity aspect. Maximisation of Earning Per Share (EPS) (2) Control (3) flexibility (4) Profitability (5) Solvency (6) Financial leverage or trading on equity (7)Cost of capital (8) Nature and size of the firm.

Cost of capital meaning and significance of cost of capital, calculation of cost of debt, preference capital, equity capital and retained earnings included in Pages-23-32.

Operating and financial leverages, measures of leverage, effect of operating and financial leverage on profit pages-43-49.In addition to that

Effect of operating and financial leverage on profit-

Leverage associated with asset acquisition or investment activities is referred to as the operating leverage. It refers to the firm's ability to use fixed operating costs to magnify the effect of changes in sales on its operating profits (EBIT) and result in more than a proportionate change in EBIT with change in the sales revenue. The operating leverage is favorable when increase in sales volume has a positive magnifying effect on EBIT .It is un favorable when a decrease in sales volume has a negative magnifying effect on EBIT.Financial leverage is related to the financing activities of a firm. It results from the presence of fixed financial charge (such as interest on debt and dividend on preference shares).Since such financial expenses do not vary with the operating profits, financial leverage is concerned with the effect of changes in EBIT on the earnings available to equity-holders.

MODULE V

Syllabus-*Dividend decision-Types of dividend-dividend models-principles of dividend policy-practical aspects of dividend.*

As per study material module IV includes dividend decisions (Page-50).Types of dividend (Page-60), dividend models (Page-50), principles of dividend policy and practical aspect of dividend included in pages-62 to 64.In addition to that

In reviewing and setting annual dividend policy, management shall be guided by the following principles:

a) **Dividend Sustainability**: To attract capital on favorable terms, and build long term shareholder value and confidence in the Company's future, the amount and frequency of dividends to be paid shall be evaluated based on the Company's ability to continue paying such dividends at an equal level in the foreseeable future. Risks that threaten the Company's ability to maintain the present level of dividends will be identified and carefully evaluated.

b) **Dividend Regularity**: To further build long term shareholder value and confidence in the Company's future, it is the objective of the Company to pay dividends on a regular basis subject to these Guiding Principles.

c) **Company Growth**: The amount, frequency and type of dividends paid should not impair or impede the ability of the Company to grow its operating income consistent with Board approved operating and capital budgets, or longer term strategic growth plans, by restricting capital necessary to grow the business.

d) **Dividend Growth:** It is the objective of the management to grow the declared dividends over time based on the Company's financial performance and condition.

Practical aspect of dividend:

Dividend policy provides a signaling mechanism of the future prospects of the corporate and, to that extent, affects its market value. In India most of the corporate have a policy of long-run dividend pay-out ratio. Dividend payments provide a bonding mechanism so as to encourage manager to act in the best interest of the shareholders. The corporate enterprises in India seem to have a tendency to pay relatively less dividends. In fact, a fairly large number of them hardly pay any dividend. The foreign controlled companies seem to follow a policy of larger distribution of profits relative to the domestic companies.Rtained earnings are a significant source of corporate finance. Investors have different relative risk perceptions of dividend income and capital gains and are not indifferent between receiving dividend income and capital gains .Management should be responsive to the shareholders preference regarding dividend and the share buyback programme should not replace the dividend payments of the corporate. Majority of Indian corporate follows a stable dividend policy in the sense that they pay either constant dividend per share in the following year with fluctuating EPS or increased dividend with increase in EPS.

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