SYLLABUS – UNIT I

• FINANCIAL ACCOUNTING DEFINITION
• IMPORTANCE OF FINANCE
• SOURCES OF FINANCE
• FUNCTIONS OF FINANCIAL MANAGEMENT
• ROLE OF A FINANCIAL MANAGER
What is Financial Management?

Concerns the acquisition, financing, and management of assets with some overall goal in mind.

Definitions

Finance management

J.F. Bradlery :-“financial business finance can be broadly defined as the activity concerned with the planning, raising, controlling and administering the funds used in the business”.

Definitions
Definition of financial management

- “Financial management is concerned with the efficient use of an important economic resource, namely capital funds”. – Solomon
- “Financial management is the application of the planning and control function to the finance function”. – Archer and Ambrosio

**Meaning of financial management**

- Financial management is application of principles of management to the subject called finance, it involves planning, controlling decision making with respect to finance activity of the business.

Video link: https://www.youtube.com/watch?v=jr_Njrgajb0
Objectives of financial management

Video link: https://www.youtube.com/watch?v=75dPbNemehk
Scope of financial management

(i) Traditional Approach:

a) The traditional approach to scope of financial management refers to its subject matter in the academic literature in the initial stage of its evolution as a separate branch of study confined to raising of funds.

b) The subject was called Corporate finance till the mid 1950’s and covered discussion on financial instruments, institutions and practices through which funds are obtained.

c) The problem of raising funds is more intensely felt at certain episodic events such as merger, liquidation, consolidation, reorganisation and so on.
(ii) Modern approach

- The approach and utility of financial management has started changing in a revolutionary manner, after 1950.
- The emphasis was shifted from raising of funds to effective and judicious utilisation of funds.
- Financial decisions have a great impact on all other business activities, the finance manager should be concerned about determining the size and nature of technology, setting the direction and growth of the business, shaping the profitability, capital structure etc.
- The modern approach is thus an analytical way of viewing the financial problems of a firm.
- The modern financial manager has to take financial decisions in the most rational way. These decisions are to be made in such a way that the funds of the firm are used optimally.
Nature of financial management

• FM is an area of decision making in finance function of the business.
• It is descriptive/ theoretical/ statistical/ historical and analytical in nature.
• It involves application of management principles to the finance function.
• It is applicable to every organization irrespective of its size, nature, place.
• It deals with accumulation and utilization of financial resources (business resources).
• It is directed towards achieving business objectives.
Scope of financial management.

1. Estimating financial requirements
2. Deciding capital structure
3. Selecting source of finance
4. Selecting pattern of investment
5. Cash management
6. Profit management
7. Ensuring liquidity
8. Meeting statutory requirement.
Financial Management Decisions

- Investment decision
- Financial decision
- Dividend decision

Financial Management Cycle

- Planning and budgeting
- Operating, monitoring, safeguarding
- Evaluation and reporting
- Resource allocation
Financial management and other functional areas

- Financial management and production management
- Financial management and material management
- Financial management and personnel management
- Financial management and marketing management
- Financial management and accounting
- Financial management and mathematics
- Financial management and economics
AN OVERVIEW OF FINANCIAL MANAGEMENT

FINANCIAL MANAGEMENT

MAXIMISATION OF THE VALUE OF A SHARE

FINANCIAL DECISIONS

INVESTMENT DECISION

FINANCIAL REQUIREMENT DECISION

FINANCING DECISION

DIVIDEND POLICY DECISION

RETURN OR PROFIT

TRADE OFF

RISK
Functions of the Financial Manager

Daily

Cash management (receipt and disbursement of funds)
Credit management
Inventory control
Short-term financing
Exchange and interest rate hedging
Bank relations

Occasional

Intermediate financing
Bond issues
Leasing
Stock issues
Capital budgeting
Dividend decisions
Forecasting

Profitability

Trade-off

Risk

Goal: Maximize shareholder wealth

Goal: Maximize shareholder wealth
Financial Managers

- Financial Managers -- *Examine financial data and recommend strategies for improving financial performance*

Financial managers are responsible for: Paying company bills, Collecting payments, Staying abreast of market changes, Assuring accounting accuracy.

Role of The Financial Manager

**Primary Functions:**
1. Performing Financial Analysis and Planning
2. Investment Decision
3. Financing Decision
4. Dividend Decision

**Emerging Roles:**
1. Financial Engineering
2. Foreign Exchange Management
3. Treasury Operators
4. Investors Communication
5. Management Control
6. Investment Planning
7. Pension Fund Management
8. Credit Manager
9. Tax Management
10. Insurance Risk Management
The Role of Finance and Financial Managers

- Auditing
- Managing taxes
- Advising top management on financial matters
- Collecting funds (credit management)
- Controlling funds (funds management)
- Obtaining funds
- Budgeting
- Planning

Cash flow diagram showcasing the interconnected roles of finance and financial managers.
SYLLABUS – UNIT II

• CAPITAL STRUCTURE MEANING
• FACTORS AFFECTING CAPITAL STRUCTURE
• DEBT EQUITY PROPORTION
• THEORIES OF CAPITAL STRUCTURE
• LEVERAGE CONCEPT
**Definition**: Capital Structure is the mix of financial securities used to finance the firm.

**Value of the Firm**

- The value of a firm is defined to be the sum of the value of the firm’s debt and the firm’s equity.
- \[ V = B + S \]
- If the goal of the management of the firm is to make the firm as valuable as possible, then the firm should pick the debt-equity ratio that makes the pie as big as possible.

FACTOR INFLUENCING CAPITAL STRUCTURE

- Business Risk
- Company Tax exposure
- Financial Flexibility
- Management Style
- Growth Rate
- Market Condition
- Cost of Fixed Assets
- Size of Business Organization
- Nature of business Organization
- Elasticity of Capital Structure
Theories of Capital Structure
Assumption of Capital Structure Theories

There are only two sources of funds i.e.: debt and equity.

- The total assets of the company are given and do no change.
- The total financing remains constant. The firm can change the degree of leverage either by selling the shares and retiring debt or by issuing debt and redeeming equity.
- Operating profits (EBIT) are not expected to grow.
- All the investors are assumed to have the same expectation about the future profits.
- Business risk is constant over time and assumed to be independent of its capital structure and financial risk.
- Corporate tax does not exit. The company has infinite life. Dividend payout ratio = 100%.
NI approach (net income approach)

- When you raise debt, leverage will increase. The overall value of the firm will increase. Debt will have lower cost, so overall cost of capital will reduce (it is better if the cost of capital reduces).
- \( V = S + D \)
- \( V = \) value of the firm, \( S = \) equity, \( D = \) debt
- An increase in leverage will increase the value of the firm, it will raise EPS, it will raise the market price of the shares and it will reduce weighted average cost of capital, thus leverage is always beneficial.
Calculation of indifference point

• The EPS formula under all-equity plan is:

\[ \text{EPS} = \frac{(1-T) \text{EBIT}}{N_1} \]

• The EPS formula under debt-equity plan is:

\[ \text{EPS} = \frac{(1-T) \left( \text{EBIT} - \text{INT} \right)}{N_2} \]

• Setting the two formulae equal, we have:

\[ \frac{(1-T) \text{EBIT}}{N_1} = \frac{(1-T) \left( \text{EBIT} - \text{INT} \right)}{N_2} \]
Net Income Approach

- **NI Approach:** A change in the proportion in capital structure will lead to a corresponding change in Ko and V.

- **Assumptions**
  1. There are no taxes;
  2. Cost of debt is less than the cost of equity;
  3. Use of debt in capital structure does not change the risk perception of investors.
  4. Cost of debt and cost of equity remains constant;
NOI approach (Net operating income approach)

- Capital structure decision is irrelevant. If you raise debt, the cost of equity will increase. The overall cost of capital will remain constant in spite of leverage. Thus there is no advantage of raising debt. As we raise the debt, the cost of equity increases in the same proportion. The market discounts the firm, which is leveraged. Thus capital structure decision has no relevance.
B) Net Operating Income (NOI)

- Net Operating Income (NOI) approach is the exact opposite of the Net Income (NI) approach.
- As per NOI approach, value of a firm is not dependent upon its capital structure.
- Assumptions –
  - **WACC is always constant, and it depends on the business risk.**
  - **Value of the firm is calculated using the overall cost of capital i.e. the WACC only.**
  - **The cost of debt \( (K_d) \) is constant.**
  - **Corporate income taxes do not exist.**
Modigliani and Miller Revisited

• M&M proposition 1: A firm’s total value is independent of its capital structure
• Assumptions needed for Prop 1 to hold:
  1. Capital markets are perfect and complete
  2. Before-tax operating profits are not affected by capital structure
  3. Corporate and personal taxes are not affected by capital structure
  4. The firm’s choice of capital structure does not convey important information to the market
MM APPROACH

FORMULA

\[ P = \frac{1}{(1 + k)} \cdot (D_1 + P_1) \]

where

- \( P \) = The prevailing market price of a share at time 0;
- \( k \) = Cost of equity capital;
- \( D_1 \) = Dividend to be received per share at time 1;
- \( P_1 \) = Market price per share at time 1.
## Difference Between Capital Structure and Capitalization

<table>
<thead>
<tr>
<th>Basis</th>
<th>Capital Structure</th>
<th>Capitalisation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Coverage</td>
<td>It refers to mix of various sources of capital E.G. Capital, debt, etc.</td>
<td>It refers to all long term securities E.G equity, debt and free reserves not meant for distribution.</td>
</tr>
<tr>
<td>Scope</td>
<td>It is an overall policy decision about the proportion of various sources of long term finance.</td>
<td>It is implementation of policy decision about capital structure.</td>
</tr>
<tr>
<td>Nature</td>
<td>It is a qualitative decision</td>
<td>It is a quantitative decision.</td>
</tr>
</tbody>
</table>
Leverages

• James Horne defines “Leverage is the employment of an asset or funds for which the firm pays a fixed cost or fixed return”.
• Leverage is the result of employment of an asset or funds having a fixed cost of return.

• VIDEO LINK: http://study.com/academy/lesson/leverage-ratios-types-formula.html
Types of Leverage

- Operating
- Financial
- Combined
Operating Leverage

- **OL** = Contribution / EBIT

- **DOL** = Percent change in EBIT
  - Percent change in Sales

Financial Leverage

- **FL** = EBIT/EBT

- **DFL** = Percent change in EPS
  - Percent change in EBIT
Combined Leverage

\[
\text{OPERATING LEVERAGE} \times \text{FINANCIAL LEVERAGE} = \frac{\text{CONTRIBUTION}}{\text{EBIT}} \times \frac{\text{EBIT}}{\text{EBT}} = \frac{\text{CONTRIBUTION}}{\text{EBIT}}
\]
SYLLABUS – UNIT III

• COST OF CAPITAL
• COST OF EQUITY
• COST OF PREFERENCE CAPITAL
• COST OF DEBT
• COST OF RETAINED EARNING
Cost of capital

The rate of return that a firm must earn on the projects in which it invests to maintain its market value and attract funds.

DEFINITION

COST OF CAPITAL IS THE MINIMUM RATE OF RETURN WHICH A FIRM REQUIRES AS A CONDITION FOR UNDERTAKING AN INVESTMENT.

MILTON H. SPENCER
COMPONENTS OF COST OF CAPITAL

i) RETURN AT ZERO RISK
ii) PREMIUM FOR BUSINESS RISK
iii) PREMIUM FOR FINANCIAL RISK

IMPORTANCE

1. CAPITAL BUDGETING DECISION
2. DESIGNING THE CAPITAL STRUCTURE
3. DECIDING ABOUT THE METHOD OF FINANCING
4. PERFORMANCE OF TOP MANAGEMENT
FACTORS DETERMINING THE COST OF CAPITAL

1. General economic conditions
2. Market conditions
3. Operating and financing decisions
4. Amount of financing

TYPES OF COST OF CAPITAL

- Historical cost and future cost
- Explicit cost and implicit cost
- Specific cost and composite cost
- Average cost and marginal cost
COMPUTATION OF COST OF CAPITAL

1. COST OF DEBT


THE COST OF DEBT IS OF TWO TYPES

a. COST OF IRREDEEMABLE DEBT
b. COST OF REDMEEEABLE DEBT
COMPUTATION OF COST OF CAPITAL

Cost Of Debt

• Cost of Redeemable Debt
  – In the previous case we have assumed that the bonds are not maturing and thus are continuously going on
  – In case the bond matures after the certain period of time then it is called redeemable debt
  – The formula to be used is

\[
k_d \text{ (before tax)} = \frac{I + (P - \text{Net Proceeds})/n}{(P + \text{Net Proceeds})/2}
\]

  – I = annual interest payment (in RS)
  – Net Proceeds = Total amount raised by the company by issuing the debentures (in Rs)
  – P = Par value of debenture (the value that the creditor gets at maturity) (in Rs)
  – n = Maturity period of the bond
COMPUTATION OF COST OF CAPITAL

Cost Of Debt

- Cost of Irredeemable Debt (issued at Premium or Discount)

\[ k_d = \frac{(1-T) \times I}{\text{Net Proceeds}} \]

- \( k = \) cost of capital (to be calculated)
- \( T = \) tax rate
- \( I = \) annual interest rate to be paid to the creditor (in Rs)
- Net Proceeds = Total amount raised by the company by issuing the debentures (in Rs)
  - In case of par --- It is equal to the par value
  - In case of discount --- it is less than par value
  - In case of premium--- it is more than the par value
COMPUTATION OF COST OF CAPITAL

2. Cost of Equity

- New common equity is raised in two ways:
  1. By retaining some of the current year’s earnings
     - Formula
     \[ r_s = \frac{D_i}{P_o} + g \]
  2. By issuing new common stock
     - Flotation cost: The cost of issuing new common stock.
     - If there is flotation cost the issuing firm receives only a portion of the capital provided by the investors, with the remainder going to the underwriter.
     - Formula
     \[ r_e = \frac{D_i}{P_o (1-F)} + g \]
COMPUTATION OF COST OF CAPITAL

Cost Of Capital

- Dividend Price Approach
  - With growth in dividends (Existing equity)
  - So formula to be used is

\[
Ke = \frac{D}{Mp} + g
\]

- Ke = Cost of Equity
- D = Dividend given
- Mp = Market price of the share
- g = expected growth in dividends
COMPUTATION OF PREFERENCE SHARE CAPITAL

VIDEO LINK:
https://www.slideshare.net/akankshagupta963871/new-microsoft-office-power-point-presentation-32612359

Cost of Preference Capital

• Cost of Preference Capital (Irredeemable)

\[ K_p = \frac{D_p}{N_p} \]
COMPUTATION OF PREFERENCE SHARE CAPITAL

Cost of Preference Capital

- Cost of Preference Capital (redeemable)

\[
K_p = \frac{D + (P - \text{Net Proceeds})/n}{(P + \text{Net Proceeds})/2}
\]

- \( D \) = Dividend on preference shares
- \( P \) = Principal to be paid to the creditors
- \( \text{Net Proceeds} \) = Amount actually received by the firm
- \( n \) = Maturity period
COMPUTATION OF WEIGHTED AVERAGE COST OF CAPITAL

\[
WACC = \frac{E}{V} \times R_e + \frac{D}{V} \times R_d \times (1 - T_c)
\]

Where:

- \( R_e \) = cost of equity
- \( R_d \) = cost of debt
- \( E \) = market value of the firm’s equity
- \( D \) = market value of the firm’s debt
- \( V = E + D \)
- \( E/V \) = percentage of financing that is equity
- \( D/V \) = percentage of financing that is debt
- \( T_c \) = corporate tax rate
SYLLABUS – UNIT IV

• DIVIDEND POLICY
• FACTORS AFFECTING DIVIDEND PAYMENT
• VARIOUS DIVIDEND MODELS
• WALTER’S MODEL
• GORDON ‘S MODEL
• MM HYPOTHESIS
Dividend

**Dividend policy** is the set of guidelines a company uses to decide how much of its earnings it will pay out to shareholders. Some evidence suggests that investors are not concerned with a company's **dividend policy** since they can sell a portion of their portfolio of equities if they want cash.

**Definition**

“A dividend is a distribution to shareholders out of profit or reserve available for this purpose”.

-Institute of Chartered Accountants of India

TYPES OF DIVIDEND

1. Regular dividend
2. Interim dividend
3. Stock dividend
4. Bond dividend
5. Property dividend
Determinants of dividend policy

i. Dividend Pay-out Ratio: It indicates the proportion of earnings distributed as dividend. Lower dividend pay-out ratio indicates conservative dividend policy.

ii. Stability of Dividend: Stable dividend policy which means they require a certain minimum percentage of dividends to be paid regularly to them.

iii. Liquidity: Payment of dividend requires availability of cash resources. Future investment opportunities should also be taken into consideration.

iv. Divisible Profit: This means dividend can be declared out of divisible profit, i.e. the profit which is legally available for distribution as dividend to the shareholders.

v. Legal Constraints: All requirements of The Company’s Act and SEBI guidelines must be kept in mind before declaring dividend.
Determinants of dividend policy

vi. Owner’s Consideration: Tax statuses of shareholders, availability of investment opportunities, ownership dilutions, etc., are the different factors that affect shareholders.

vii. Capital Market Conditions and Inflation: Capital market conditions and inflation play a dominant role in developing the dividend policy.

Objectives of Dividend Policy:

i. Wealth Maximization: Dividend policy should be developed keeping in mind the wealth maximization objective of the firm.

ii. Future Prospects: Dividend policy is a financing decision and leads to cash outflows and also leads to decrease in availability of cash for financing of profitable projects.
Objectives of Dividend Policy

iii. Stable Rate of Dividend: Fluctuation in the rate of return adversely affects the market price of shares.

iv. Degree of Control: Issue of new shares or dependence on external financing will dilute the degree of control of the existing shareholders.

NATURE OF DIVIDEND POLICY

1. Stability of earnings
2. Age of firm
3. Regularity and stability in dividend payment
4. Time for payment of dividend
5. Liquidity of funds
NATURE OF DIVIDEND POLICY

6. Policy of control
7. Repayment of loan
8. Government policies
9. Legal requirements
10. Trade cycles
11. Need for additional capital
12. Ability to borrow
13. Extent of share distribution
14. Past dividend rates
Dividend Theories

Relevance Theories
(i.e. which consider dividend decision to be relevant as it affects the value of the firm)
- Walter’s Model
- Gordon’s Model
- Modigliani and Miller’s Model

Irrelevance Theories
(i.e. which consider dividend decision to be irrelevant as it does not affect the value of the firm)
- Traditional Approach
Walter’s Model

- Prof. James E Walter argued that in the long-run the share prices reflect only the present value of expected dividends. Retentions influence stock price only through their effect on future dividends. Walter has formulated this and used the dividend to optimize the wealth of the equity shareholders.

- Assumptions of Walter’s Model:
  - Internal Financing
  - constant Return in Cost of Capital
  - 100% payout or Retention
  - Constant EPS and DPS
  - Infinite time
FORMULA OF WALTER’S MODEL

\[
P = \frac{D + r (E-D)}{k}
\]

Where,

\( P \) = Current Market Price of equity share
\( E \) = Earning per share
\( D \) = Dividend per share
\( (E-D) \) = Retained earning per share
\( r \) = Rate of Return on firm’s investment or Internal Rate of Return
\( k \) = Cost of Equity Capital
Criticisms of Walter’s Model

- No External Financing

- Firm’s internal rate of return does not always remain constant. In fact, r decreases as more and more investment is made.

- Firm’s cost of capital does not always remain constant. In fact, k changes directly with the firm’s risk.
Gordon’s Model

- According to Prof. Gordon, Dividend Policy almost always affects the value of the firm. He showed how dividend policy can be used to maximize the wealth of the shareholders.

- **Assumptions:**
  - All equity firm
  - No external Financing
  - Constant Returns
  - Constant Cost of Capital
  - Perpetual Earnings
  - No taxes
  - Constant Retention
  - Cost of Capital is greater than growth rate \((k > br = g)\)
Formula of Gordon’s Model

\[ P = \frac{E (1 - b)}{K - br} \]

- Where,
  - \( P \) = Price
  - \( E \) = Earning per Share
  - \( b \) = Retention Ratio
  - \( k \) = Cost of Capital
  - \( br = g \) = Growth Rate

Criticisms of Gordon’s model

- As the assumptions of Walter’s Model and Gordon’s Model are same so the Gordon’s model suffers from the same limitations as the Walter’s Model.
Modigliani and Miller’s Approach

- Assumption
  - Capital Markets are Perfect and people are Rational
  - No taxes
  - Floating Costs are nil
  - Investment opportunities and future profits of firms are known with certainty (This assumption was dropped later)
  - Investment and Dividend Decisions are independent
Formula of M-M’s Approach

\[ P_0 = \frac{1}{1 + p} (D_1 + P_1) \]

Where,
- \( P_0 \) = Market price per share at time 0,
- \( D_1 \) = Dividend per share at time 1,
- \( P_1 \) = Market price of share at time 1
Criticism of M-M Model

- No perfect Capital Market
- Existence of Transaction Cost
- Existence of Floatation Cost
- Lack of Relevant Information
- Differential rates of Taxes
- No fixed investment Policy
- Investor’s desire to obtain income
SYLLABUS

• WORKING CAPITAL REQUIREMENT
• COMPONENTS OF WORKING CAPITAL
• OPERATING CYCLE
• FACTOR INFLUENCING WORKING CAPITAL
• FORECASTING WORKING CAPITAL REQUIREMENT
What is working capital?

**Working capital** is calculated by subtracting current liabilities from current assets. Current assets include cash, marketable securities, inventory, accounts receivable and other short-term assets to be used within the year.
For estimation of working capital, following four step procedure is applicable:

- Estimation of cash cost of the various current assets required by the firm.
- Estimation of current liabilities of the firm.
- Calculation of net working capital.
- Add percentage of contingency.


VIDEO LINK: [https://www.youtube.com/watch?v=eaGgCJtHxuE](https://www.youtube.com/watch?v=eaGgCJtHxuE)
Where...

- **Raw Material** = Budgeted Production in Units * Raw Material Cost per unit * Average Raw material Holding Period / 12 months or 365 days.

- **WIP** = Budgeted Production in Units * Estimated WIP Cost per unit * Average WIP Holding Period / 12 months or 365 days.

- **Finished Goods Inventory** = Budgeted Production in Units * Cost of Goods produced * finished Goods Holding period / 12 months or 365 days.

- **Investment in Debtors** = Budgeted Credit Sales in Unit * Cost of Sales per Unit * Average Debt Collection Period / 12 months or 365 days.
Estimation of Current Liabilities…

- **Creditors** = Budgeted Production in Units * Raw Material Cost per unit * Credit period Allowed by Suppliers / 12 months or 365 days.

- **Direct Wages** = Budgeted Production in Units * Direct Wages Cost per unit * Lag in Payment of Wages / 12 months or 365 days.

- **Overheads** = Budgeted Production in Units * Overhead Cost per unit * Lag in Payment of Overheads / 12 months or 365 days.

Operating cycle…

- Operating cycle is the time that elapses to convert raw materials into cash.
  - Operating cycle of Manufacturing firm.
  - Operating cycle of a Non manufacturing firm.

Operating cycle...
Concepts of Working Capital

1. Gross Working Capital
   - Total Current assets
   - Where Current assets are the assets that can be converted into cash within an accounting year & include cash, debtors etc.
   - Referred as “Economics Concept” since assets are employed to derive a rate of return.

2. Net Working Capital
   - CA – CL
   - Referred as ‘point of view of an Accountant’.
   - It indicates liquidity position of a firm & suggests the extent to which working capital needs may be financed by permanent sources of funds.
OPERATING CYCLE OF MANUFACTURING FIRM

CASH → RAW MATERIALS → WORK-IN PROGRESS → FINISHED GOODS → DEBTORS → CASH
OPERATING CYCLE OF TRADING FIRM

CASH → FINISHED GOODS → DEBTORS → CASH
Sources of working capital

Sources of Working capital

Long term sources

Short term sources

Internal

External
Determinants of working capital

- General nature of business
- Production cycle
- Business cycle
- Credit policy
- Production policy
- Growth and expansion
- Profit level
- Operating efficiency