What is financial Management? Scope or Approaches of financial Management and functions of financial Management?

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DOMS

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Financial Management

Introduction

Finance

finance is considered as the life blood of any business without which no business can survive. finance is defined as the provision of money at the time when it is required. The role of finance in business enterprise needs no emphasis. Every enterprise, whether big or small, needs finance to carry on and expand its operations. finance holds the key to all the business activities and a firm's success.

Financial Management

The meaning of financial Management is to arrange funds for the business. The term 'financial management' is used in a wider sense, in which not only collection of liquid resources are included but its efficient planning and application are also included. financial Management is that part of managerial process which is concerned with planning and controlling of firm's financial resources.

Scope of Business finance
Or
Approaches to finance function or financial Management

financial Management emerged as a distinct field of study. In the early years of its evolution its role was limited only to be collecting of required funds. At present it is universally recognised that in addition to the procurement of funds it includes their efficient use as well. The role of financial management is assuming greater significance in solving the complex problems of the business. In order to express the changing role of finance manager, it is essential to study the scope or approaches to the finance function.

Approaches

Traditional Approach — Modern Approach

- Traditional Approach

Under this approach the role of financial management was limited to the procurement of funds on suitable terms. The utilisation of funds was considered out of the scope of financial management. Under this approach, a study of the following three things was made for the procurement of funds

a) Institutional source of finance

b) Issue of financial instruments through which funds are raised from capital market

c) Legal and accounting relationships between a

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business and source of funds.

Limitations of Traditional Approach

(i) More Emphasis on Raising of funds
This approach places more emphasis on procurement of funds from external sources and neglects the issues relating to the efficient utilisation of funds. Since, it is concerned with the raising of funds, it attaches more importance to the viewpoint of external parties such as financial institutions, bankers, investors etc who provide funds to business.

(ii) Narrow Approach
The scope of financial Management is very limited under this approach which is confined only with the arrangement for the acquisition of funds for corporate enterprises.

(iii) Ingore the Routine Problems
In this approach, the financial problems of a firms are resolved only on the happening of certain events like incorporation or promotion of a firm, amalgamation and reconstruction & so on.

(iv) Focus on Long-term financing
The main focus is always on the long term financing requirements of the business in the traditional approach. In fact, a firm has not to devote its total concentration on long term projects, but it has to make certain short-term investments, also known a

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working capital Management.

(V) Ingore the financial Problems of Non-Corporate Sector.

Modern Approach

The modern approach of financial management is a wider concept which present an analytical viewpoint on economic problems. The modern approach of financial management could emerge due to the fundamental limitations of the traditional approach and the ever-changing business environment.

Characteristics of Modern Approach
Or
Nature & Characterestics of Financial Management

(i) Wider Scope

The area of modern approach is quite wide. The main focus is not only the acquisition of funds but also on its effective deployment. It consists the allocation of funds according to the different short-term and long term needs of business.

(ii) Analytical

The modern approach is less ~~attractive~~ narrative but more analytical. While focusing on the internal & external circumstances of the business

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iii) Attention towards both long and short term requirements

The traditional approach was mainly concerned with the long term financial problems of the firm. But the modern approach gives the same importance to all the financial needs whether they are short term or long term.

iv) Financial Management as a continuous Process

While the old approach considered that the financial management is more relevant on the happening of certain events like incorporation of companies, merger etc. The modern approach considers it as a routine activity and a continuous process.

(v) Insider - looking out Approach

The modern approach of financial management includes in its sphere, all the following three decisions

(i) Financing decisions
(ii) Investment Decisions
(iii) Dividend or Distribution Decisions

Financing decision
An estimate of the requirements of funds is made under such decisions which is known as financial Planning. With the help of sound financial planning, the firm may be saved from the dangers of over-capitalisation

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as well as under-capitalisation. When the short term and long term financial needs of the business are estimated, then it is seen what are the various options before the business to arrange for the funds, namely, Equity shares, preference shares, debentures or borrowings from financial institutions and so on.

Factors affecting the financing decision

(i) **Cost**

The cost of raising funds from different sources are different. A wise financial manager normally opt for a source which is cheapest. The cost of each type of finance is estimated.

(ii) **Risk**

Risk associated with each source is also different. More Risk is associated with borrowed fund as compared to owner's fund securities.

(iii) **Floatation Cost**

The cost involved in issue of securities such as broker's commission, underwriter fees, expenses on prospectus etc. is called floatation cost.

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Investment Decisions

After the acquistion of funds it it rather more important to deploy them in the business effectively. The investment of funds may be classified into two parts - long-term and short term investments. The long-term investments directly effect the profitability of a concern and they may be called capital budgeting

Factors affecting the Investment decisions

(i) Cash flow of the Projects

Availability of funds exercises a significant influence on investment decision. When a company invests huge amount of funds in some project, it expects regular amount of cash inflow from that project.

(ii) Rate of Return

Return expected from the investment is a major factor influencing investment decision. The company compares the return from different investment proposals. The desired project is selected after comparing expected returns of different projects.

(iii) Investment Criteria Involved

The decision to invest in a particular project involves a number of calculations regarding the amount of investments, interest rate, cash flows and rate of return.

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Dividend Decisions
From the operating of the business, first of all, the interest on long term loans is paid and then the taxes of the government and dividend on preference shares is paid. Finally, the amount remaining after such payments, is available for dividend to equity shareholders

factors affecting the Dividend Decision

(i) Earnings
Dividend is paid out of current and past earnings. If there are more earnings then company declares higher rate of dividend whereas during low earning period, rate of dividend is low.

(ii) Stability of Earnings
Companies having stable and smooth earnings prefer to give high rate of dividend whereas companies with unstable of earnings prefer to give low rate of earnings.

(iii) Stability of dividend
Some companies follow a stable dividend policy as it better impact on shareholders and improves the reputation of company.

(iv) Growth opportunities
If company has a number of projects to

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invest in, the company would prefer to pay low dividends & invest the remaining profits of business

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Functions of Financial Management

There are three basic functions of financial Management. These are: (i) Raising finance, Investing it in assets and distributing returns earned from assets to shareholders. These functions are known as financial decision, Investment decision and Dividend decision. While performing these functions, various other functions have also to be performed such as taking working capital decisions and planning and controlling the finance. The functions of finance are

(i) Determining the financing Decision
(ii) Financing Decision
(iii) Investment Decision
(iv) Dividend Decision
(v) Working Capital decision
(vi) Financial control
(vii) Routine functions.

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(i) Determining the financial Needs
The first task of financial management is to estimate and determine the financial requirements of the business. For purpose the short term and long term needs of the business are estimated separately.

(v) Working capital Decision
It is concerned with the management of current assets. It is an important function of financial Management since short-term survival of the firm is a pre-requisite for its long term success.

(vi) financial control
The establishment and use of financial control devices is an important function of financial Management. These devices include budgetary control, cost control, ratio analysis etc.

(vii) Routine functions
for the effective execution of the finance functions, certain routine functions have to be performed in the normal course of business. The Routine functions are:-
a) Supervision of cash Reciepts & payments & Safeguarding of cash balance.
b) Opening bank accounts & managing them.
c) Safeguarding of securities, insurance policies & other valuable documents.

What are the objectives or goals of financial Management?

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Objectives of financial Management

It is the duty of the top management to lay down the objectives or goals which are to be achieved by the business. Objectives lay down a criterion by which the efficiency & profitability of a particular decision is evaluated. The choice of such a criterion lies b/w profit maximisation & wealth maximisation. Hence, there are two approaches :-

i) Profit Maximisation
ii) Wealth maximisation

Profit Maximisation - According to this approach, all activities which increase profits should be undertaken & which decrease profits should be avoided. Profit maximisation implies that the financial decision making should be guided by only one test, which is, select those assets, projects & decisions profitable

FAVOUR IN PROFIT MAXIMISATION

i) Measurement of performance -
Profit is a test of economic efficiency of a business. It is yardstick by which the economic performance of a business can be judged.

ii) Efficient Allocation & utilisation of resources
Profit maximisation leads to efficient allocation

of resources & utilisation of resources of the business because sources tend to be directed to uses from less profitable projects to more utilisation projects.

iii) Maximisation of social welfare- Profitability is essential for fulfilling the goal of social welfare also. Maximisation of profits leads to maximisation of social welfare

iv) Helpful in the growth of the firm:- Profits are the main source of finance for a growth of a firm.

v) Source of incentive Profit motivate them to
Profit motived
Pace of develop &

AGAINST OF PROFIT MAXIMISATION

i) Ambiguous- One practical difficulty with this approach is that term is vague and ambiguous. Different people take different meaning of term profits.

ii) Ignores the Time value of Money. This approach ignores the time value of money i.e it does not make a distinction b/w profits earned over the different years. It ignores the fact that value of one ruppee at present is greater than the value of same rupee received after 1year.

iii) Ignores Risk factor- This approach ignores the risk associated with the earnings. If the 2 firms have the same total expected earnings, but if earnings of one firm fluctuate considerily as compared to other.

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iv) Ignores future profits - The business is not solely run with the objective of maximising immediate profits. Some firms place more importance on growth of sales. They are willing to accept lower profits to achieve stability provided by a large volume of sales.

v) Ignores Social obligations of Business.

vi) Neglects the effect of dividend policy on Market Price of shares.

Wealth Maximisation -

This approach is now universally accepted as an appropriate criterion for making financial decision as it removes all the limitations of profit maximisation approach. It is also known as net present value (NPV) in terms of benefits received from it use less the cost of its acquisition. Benefits are measured in terms of cash flows received from it use rather than accounting profits.

$$W = \frac{A_1}{(1+k)} + \frac{A_2}{(1+k)^2} + \cdots + \frac{A_n}{(1+k)^n} - C$$

Profit Max. v/s Wealth Max.

2) It uses cash flow instead of accounting profits which avoids the ambiguity regarding the exact meaning of the term profit.

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ii) It gives due importance to the time value of money by reducing the funds cash flow by an app discount or interest rate. If higher risk & longer time period are involved, higher rate of discount or interest rate will be used to find out of present value of future cash benefits.

iii) It gives due importance to payment of regular dividends: In this approach, financial decisions are taken in such a way that the shareholders receive higher combination of dividends & increase in the market price of the shares.

4) The best course of action can be selected out of diff. alternatives.

5) It gives due importance of social responsibility of the business

Importance of financial management:-

i) Helpful in acquiring sufficient funds:-
Financial management is helpful in assessing the financial needs of the business, preparing an optimum capital structure & then raising the finance from appropriate sources of finance.

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ii) Proper utilisation of resources:-

Financial management uses the funds in such a way that maximum benefit is derived from them. The benefits received from their use are compared with their cost.

iii) Proper cash management:-

Financial management assesses various cash needs at diff. times & then arranges cash for meeting these needs. Cash may be needed for purchase of raw materials, payments of creditors, payment of wage bills and for paying day-to-day expenses.

iv) Proper use of profits-

Judicious use of profits is essential for expansion & diversification of the concern. Although the ploughing back of profits is the best source of finance but it clashes with the interest of shareholders.

v) Maximisation of wealth-

Financial management ensures that the investment decision, financing decision & dividend decision are taken in such a way that they result in maximisation of wealth of the concern.

vi) Useful for investors-

If the investors have sufficient knowledge of the principles of financial management, they will be able to decide whether a company's securities should be purchased or not.

vii) Useful for shareholders.

viii) Useful for banks.

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What is Capital Budgeting? Importance and kinds of capital ~~capital~~ Budgeting?

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Capital Budgeting

Meaning

Capital Budgeting is the technique of making decisions for investment in long-term assets. It is a process of deciding whether or not to invest the funds in a particular asset, the benefit of which will be available over a period of time longer than one year

Defination

Capital Budgeting involves the planning of expenditures for assets, the returns from which will be realised in future time periods.

features of Capital Budgeting Decisions

(i) funds are invested in long-term assets.

(ii) funds are invested in present times in anticipation of future profits.

(iii) The future profits will occur to the firm over a series of years.

(iv) Capital Budgeting decisions involve a high degree

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Risk because future benefits are not certain.

Importance of Capital Budgeting

(i) Such decisions affect the Profitability of the firm

Capital Budgeting decisions affect the long-term profitability of a firm because of the fact that they releave to fixed assets. The fixed assets reflect the true earning capacity of the firm.

(ii) Long time periods

The effect of a capital budgeting decisions will be felt by the firm over a long time span, and thus, affects the future cost structure of the firm.

(iii) Irreversible Decisions

Capital Budgeting decisions, once taken, are not easily reversible without heavy financial loss of the firm. This is because it is very difficult to sell the second hand plant.

(iv) Involvement of Large Amount of funds

Capital Budgeting decisions require large amount of funds and most of the firms have limited financial resources. Hence, it is absolutely necessary to take thoughtful and correct investment decisions.

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(v) Risk
Investment in fixed assets may change the risk complexion of the firm. This is because different capital investment proposals have different degrees of risk.

(vi) Most Difficult to make
These decisions are among the most difficult decisions to be taken by a firm. This is, because they require an assessment of future events which are uncertain and difficult to predict.

Kinds of Capital Budgeting decisions

(i) Accept-Reject Decisions
This is a fundamental decision in capital budgeting. If a proposal is accepted, the firm would invest in it and if the proposal is rejected, the firm would not invest in it. In general, all those proposals which yield a rate of return higher than a certain required rate of return are accepted and rest are rejected.

(ii) Mutually Competitive Decisions
These are related to the proposals which compete with other projects in such a way that the acceptance of one will automatically result in rejection of others.

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(iii) Priority Order Decisione

In case where a firm has unlimited funds, all those independent projects are accepted which yield a higher rate of retuen as against some predetermined rate. However, in actual practice most of the firms have limited funds.

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Explain Working capital ?. Nature and Planning of Working Capital and Types of Working capital?

Working capital management is an important aspect of financial management. In business, money is required for fixed assets and working capital. Fixed assets include land and building, plant and machinery, furniture and fittings etc. Fixed assets are acquired to be retained in the business for a long period and yield returns over the life of such assets. Working capital, on the other hand, is required for the efficient and effective use of fixed assets. The main objective of working capital management is to determine the optimum amount of working capital required.

Meaning and Concepts of Working Capital

There are two concepts of working capital :

(i) Gross Working Capital Concept

(ii) Net Working Capital Concept

(i) **Gross Working Capital Concept** : According to this concept, working capital means Gross Working Capital which is the total of all the current assets of a business.

Gross Working Capital = Total Current Assets

Definitions favouring this concept are :

1. "Working Capital means total of Current Assets."—*Mead, Mallott and Field*
2. "Any acquisition of funds which increases the Current Assets increases Working Capital, for they are one and the same." —*Bonneville and Dewey*

Persons acknowledging the total of current assets as working capital give the following arguments in their favour :

(i) Just as fixed assets are considered as the symbol of fixed capital, current assets must also be considered as symbol of working capital.

(ii) Any acquisition of funds increases the working capital. This statement proves true according to this concept whereas it does not hold true according to the second concept.

(iii) Most of the managers plan their business operations according to the current assets concept because these are the assets used in day-to-day business operations.

(iv) Utility of current assets remains the same whether financed from long-term loans or short-term loans. Hence, the total amount of current assets must be treated as working capital.

(2) **Net Working Capital Concept** : According to this concept, working capital means net working capital which is the excess of current assets over current liabilities.

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Net Working Capital = Current Assets – Current Liabilities

Definitions favouring this concept are :

1. "It has ordinarily been defined as the excess of current assets over current liabilities." —*C.W. Gestenbergh*
2. "The most common definition of net working capital is the difference of firm's current assets and current liabilities." —*Lawrence. J. Gitmen*

Persons favouring this concept give the following arguments in their favour :

(*i*) This concept gives the true information about the liquidity of a concern. According to first concept, the working capital appears to be increased merely by taking a short-term loan whereas in the second concept working capital remains unchanged by doing so. Thus, the second concept looks more logical. In actual sense, working capital increases only by ploughing back of profits or when a long-term loan is obtained.

(*ii*) Excess of current assets over current liabilities will indicate whether or not the concern will be able to meet its current liabilities when they fall due. First concept does not disclose this fact.

(*iii*) It is on the basis of this concept that the short-term lenders, bankers etc. calculate the safety margin regarding the timely payment of their debt.

(*iv*) Excess of current assets over current liabilities will determine whether or not the concern will be able to face the depression or any other contingent need of the business.

(*v*) According to this concept a comparison can be made between the financial position of two firms whose current assets are equal.

As discussed, net working capital is the excess of current assets over current liabilities. If current assets are equal to current liabilities, net working capital will be zero and if current liabilities are more than current assets, net working capital will be negative.

Current assets mean those assets which are converted into cash within a short period of time not exceeding one year, *e.g.,* cash, bank balance, debtors, bills receivable, stock, accrued income etc.

Current liabilities mean those liabilities which have to be paid within a short period of time in no case exceeding one year, *e.g.,* creditors, bills payable, outstanding expenses, short-term loans etc.

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Nature of Working Capital
Or
Need for Working Capital

Alongwith the fixed capital almost every business requires working capital though the extent of working capital requirement differs in different businesses. Working capital is needed for running the day-to-day business activities. When a business is started, working capital is needed for purchasing raw materials. The raw material is then converted into finished goods by incurring some additional costs on it. Now goods are sold. Sales do not convert into cash instantly because there is invariably some credit sales. Thus, there exists a time lag between sales of goods and receipt of cash. During this period, expenses are to be incurred for continuing the business operations. For this purpose working capital is needed. Therefore, sufficient working capital is needed which shall be involved from the purchase of raw materials to the realisation of cash. The time period which is required to convert raw materials into finished goods and then into cash is known as operating cycle or cash cycle. The need for working capital can also be explained with the help of operating cycle. Operating cycle of a manufacturing concern involves five phases :

(*i*) Conversion of cash into raw material

(*ii*) Conversion of raw material into work-in-progress

(*iii*) Conversion of work-in-progress into finished goods

(*iv*) Conversion of finished goods into debtors by credit sales

(*v*) Conversion of debtors into cash by realising cash from them.

Thus the operating cycle starts from cash, finishes at cash and then again restarts from cash. Need for working capital depends upon period of operating cycle. Greater the period, more will be the need for working capital. Period of operating cycle in a manufacturing concern is greater than period of operating cycle in a trading concern because in trading units cash is directly converted into finished goods.

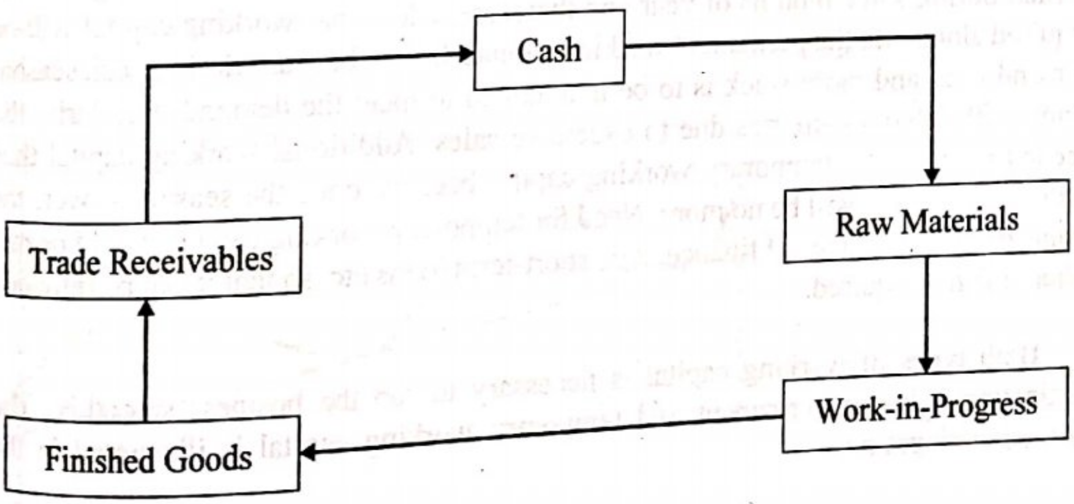

Diagram : Operating Cycle (Nature of Working Capital)

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Because of the time involved in a operating cycle, there is a need of working capital in the form of current assets. Firms have to keep adequate stock of raw-materials to avoid risk of non-availability of raw materials. Similarly, concerns must have adequate stock of finished goods to meet the demand in market on continuous basis and to avoid being out of stock. Concerns also have to sell finished goods on credit due to competition which necessiates the money tied up in debtors and bills receivables. In addition to all these, concerns have to necessarily keep cash to pay the manufacturing expenses etc. and to meet the contingencies.

Types of Temporary Working Capital

Working capital in a business is needed because of operating cycle. But the need for working capital does not come to an end after the cycle is completed. Since the operating cycle is a continuous process, there remains a need for continuous supply of working capital. However, the amount of working capital required is not constant throughout the year, but keeps fluctuating. On the basis of this concept, working capital is classified into two types :

(*a*) **Permanent Working Capital** : The need for working capital or current assets fluctuates from time to time. However, to carry on day-to-day operations of the business without any obstacles, a certain minimum level of raw-materials, work-in-progress, finished goods and cash must be maintained on a continuous basis. The amount needed to maintain current assets on this minimum level is called permanent or regular working capital. The amount involved as permanent working capital has to be met from long-term sources of finance, *e.g.*, capital, debentures, long-term loans etc.

(*b*) **Temporary or Variable Working Capital** : Any amount over and above the permanent level of working capital is called temporary, fluctuating or variable working capital. Due to seasonal changes, level of business activities is higher than normal during some months of year and therefore, additional working capital will be required alongwith the permanent working capital. It is so because during peak season, demand rises and more stock is to be maintained to meet the demand. Similarly, the amount of debtors increases due to excessive sales. Additional working capital thus needed is known as temporary working capital because once the season is over, the additional demand will be no more. Need for temporary working capital should be met from short term sources of finance, *e.g.*, short-term loans etc. so that it can be refunded when it is not required.

Both types of working capital is necessary to run the business smoothly. The distinction between permanent and temporary working capital is illustrated in the following diagram :

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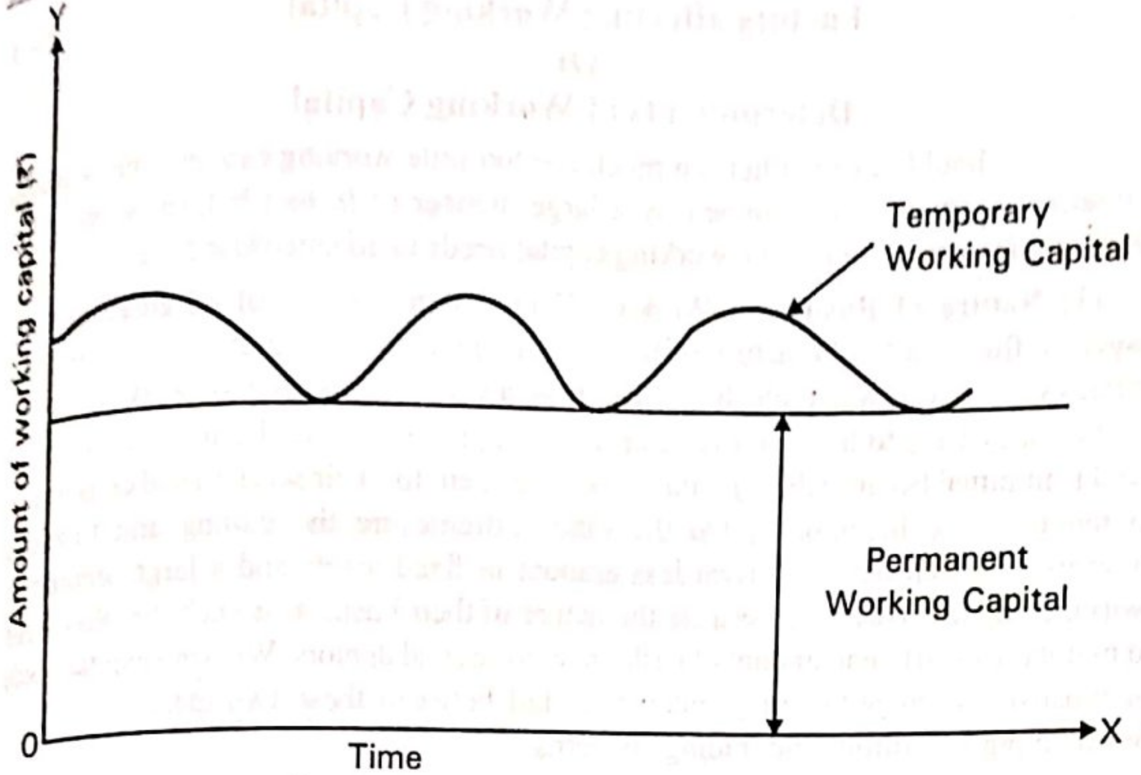

Diagram : Showing Permanent and Temporary Working Capital

Above diagram shows that permanent working capital remains the same throughout the year, while temporary working capital is fluctuating in accordance with seasonal demand.

However, in case of an expanding concern, the need for permanent working capital may not be constant and it would be increasing . Therefore, the permanent working capital line also may not be horizontal and it will go on rising as illustrated in the following diagram :

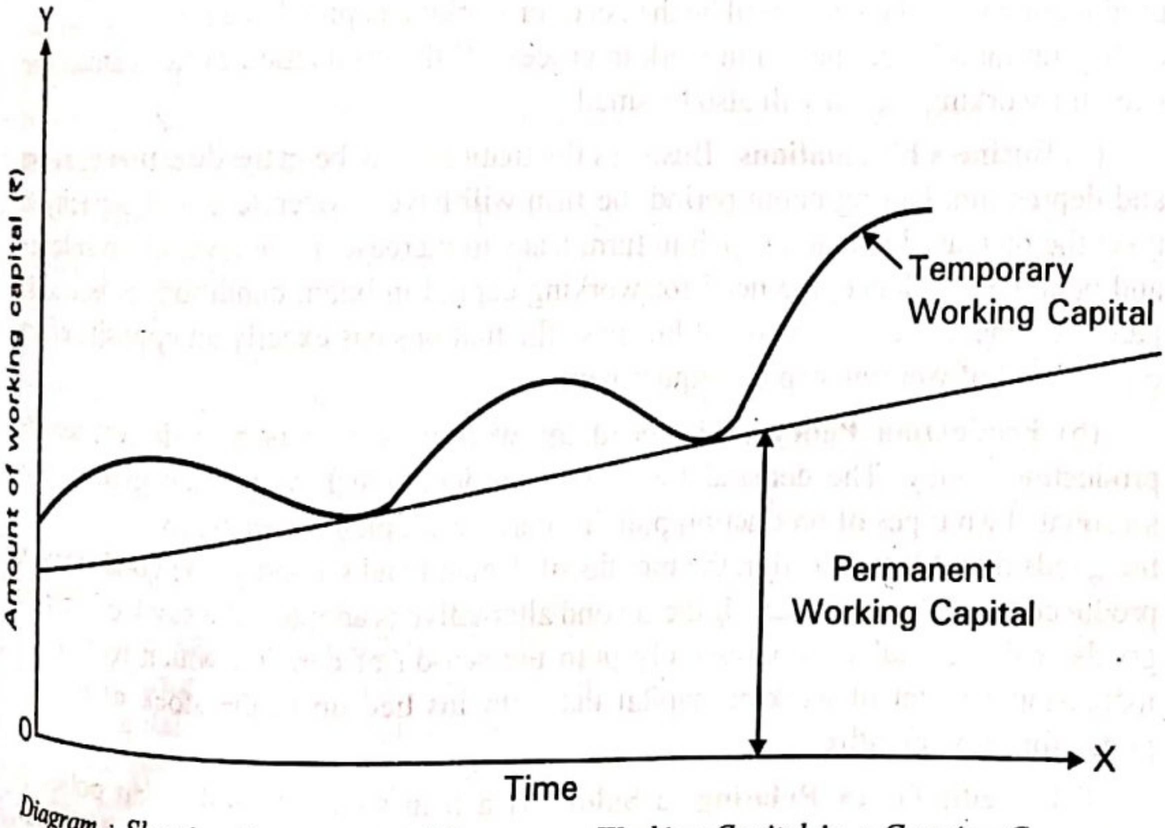

Diagram : Showing Permanent and Temporary Working Capital in a Growing Concern

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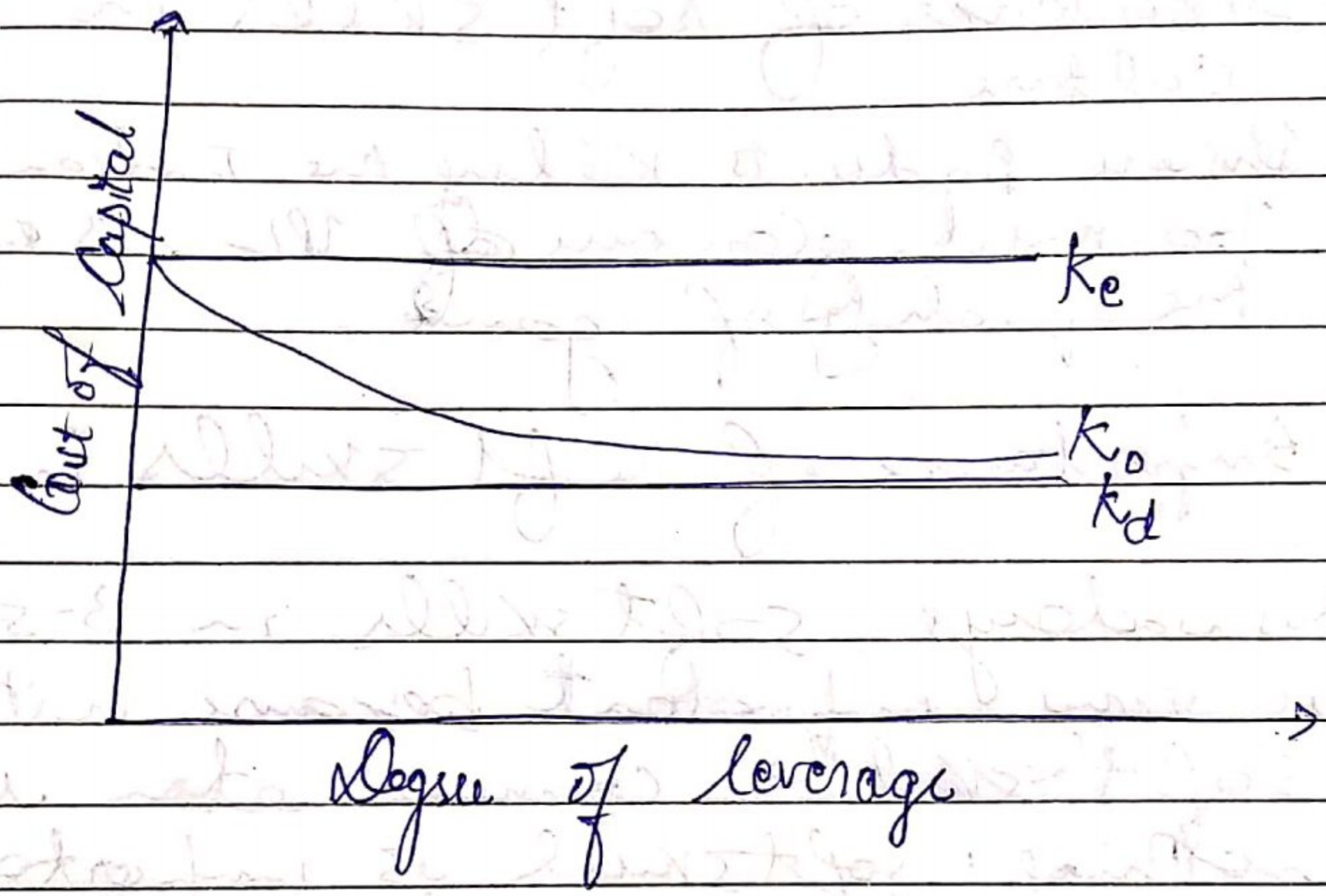
Cost of Capital
k_e
k_o
k_d
Degree of leverage

What are Approaches of Capital Structure?

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Capital Structure Theories

Capital Structure theories have been profounded by various authors like David Durand, Ezra Solomon, Modigliani and Miller. Although there are various theories but the important ones are :-

(i) Net Income Approach
(ii) Net Operating Income Approach
(iii) Traditional Approach
(iv) Modiglani and Miller Approach

K_O = Overall Cost of Capital K_E = Cost of Equity
V = Value of firm K_d = Cost of debt

1. Net Income Approach

1. According to NI Approach, as suggested by Durand
2. Capital Structure decision is relevant value of the firm.
3. It supports that the employee of debt leads to increase in the value of firm and decrease in overall cost of capital
4. $V = S + B$

   V = Value of the firm
   S = Market value of Equity
   B = Market value of Debt

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Net Operating Income Approach
(Durand)

1) It's opposite to the Net Income Approach.

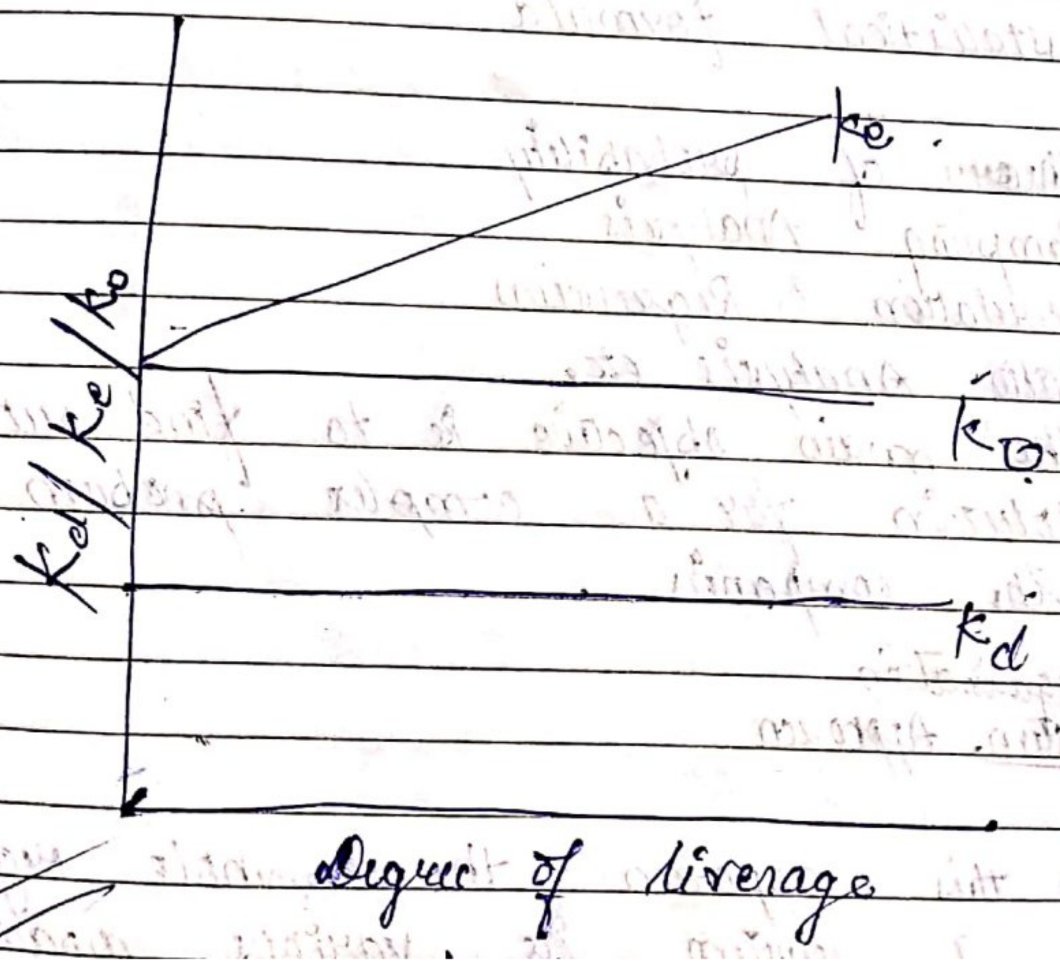
2) According to this theory, capital structure decision is irrelevant for the firm. (means any change in composition of capital str. i.e debt & Equity does not effect the market value of firm) and overall cost of capital will remain constant.

3) It means the overall cost of capital will remain constant whatever the comp. may be i.e 50%, 50% and 40%, 60% etc.

Assumptions

1) Cost of debt is lower than Cost of Equity.
2) There are no corporate and personal income taxes.
3) Risk perception of the lenders do not change with the change in financial leverage. So cost of debt remain constant at all levels of financial leverage.
4) The market capitalise the value of firm as a whole so comp. of debt & Equity is not important.

According to this approach with the constant use of dist will lead to increase the risk preception of Equity shareholders and equity share-holders are expected a higher rate of return which will lead to increase in cost of Equity. whereas the cost of dist remain constant as the risk preception of the lenders will not affected ∴ debt is exactly off set. Overall cost of capital remain constant at all levels of financial liverage.



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3. Traditional Approach

The traditional approach establishes a compromise or a midway between the Net Income Approach and the Net Operating Income Approach. It resembles Net Income (NI) Approach in arguing that overall cost of capital and the value of the firm are both affected by capital structure decision. But it does not subscribe to the view of NI Approach that use of debt in capital structure to any extent will necessarily decrease the overall cost of capital and increase the value of the firm. It resembles Net Operating Income (NOI) Approach that beyond a certain degree of leverage, the cost of equity (K_e) increases. But it differs from the NOI Approach that overall cost of capital (K_o) and the value of the firm are constant for all degrees of leverage.

The Crux of the traditional approach is that through judicious use of debt, a firm can reduce its overall cost of capital (K_o) and can increase the value of the firm. The rationale behind this view is that debt is a relatively cheaper source of funds as compared to equity shares. A change in the leverage, that is, using more debt in place of equity causes a decline in overall cost of capital. However, it occurs within a resonable limit of debt. If the proportion of debt is increased beyond a certain point the overall cost of capital starts increasing and firm's market value begins to decline. Thus, an optimum capital structure exists, and it occurs at that degree of financial leverage where overall cost of capital is minimum and the value of the firm is maximum.

According to the traditional approach, the manner in which the overall cost of capital and the value of the firm reacts to changes in the degree of financial leverage can be divided into three stages :

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First Stage

In the first stage, increase in financial leverage, *i.e.* the use of increased debt in the capital structure results in decrease in the Overall Cost of Capital (K_o) and increase in the Value of the Firm. This is because, a relatively cheaper source of funds debt replaces a relatively costlier source of funds equity. In this stage, cost of equity (K_e) remains constant or rises negligibly. Cost of debt (K_d) also remains constant or rises negligibly since the market considers the use of debt as a reasonable policy at this stage.

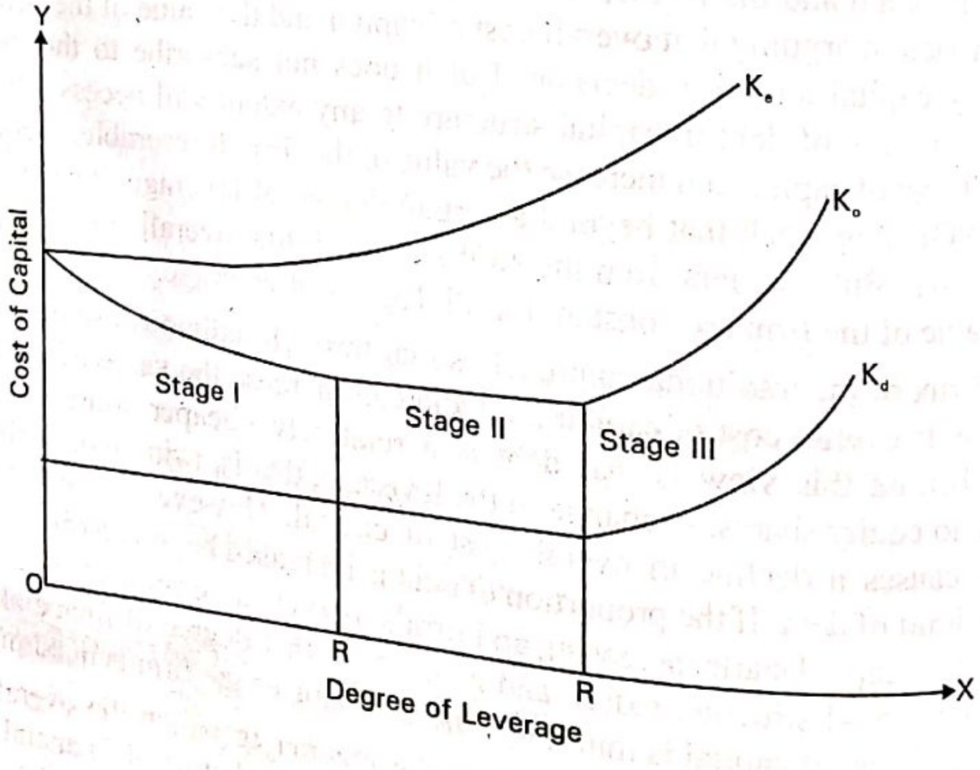
Second Stage

Once the firm has reached a certain degree of financial leverage, increase in leverage does not affect the Overall Cost of Capital and the Value of the Firm. This is because the increase in the cost of equity (K_e) due to added financial risk completely offsets the advantage of using cheaper debt capital. Within that range or at a particular level of leverage the overall cost of capital will be minimum and the value of the firm will be maximum. This range or level represents optimum capital structure.

Third Stage

In the third stage, the further increase in debt will lead to increase in Overall Cost of Capital and will reduce the Value of the Firm. This happens due to two factors : (*i*) Owing to increased financial risk, K_e will rise sharply and (*ii*) K_d would also rise because the lenders will also raise the rate of interest as they may require compensation for higher risk.

The behaviour of K_d, K_e and K_o has been graphically shown in the following figure :



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What is capital structure? factors affecting or determining the capital structure?

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Assignment - 7

CAPITAL STRUCTURE......

The term 'capital structure' refers to the proportion between the various long-term sources of finance in the total capital of the firm. The major sources of long term finance include 'proprietor's funds' and 'Borrowed funds'. Proprietors funds include equity capital, Preference capital, Reserves & surpluses and Borrowed funds include long-term debts such as loan from financial institutions, debentures etc.
In the capital structure decisions, it is determined as to what should be the proportion of each of the above sources of finance in the total capital of the firm.

Optimum Capital structure

1.) Simplicity: The capital structure should be simple, as far as possible. Simplicity means that in addition to equity & preference capital, the minimum type of long-term securities should be issued. Initially only equity & preference shares should be issued.

2.) Flexibility: The capital structure should be adequently flexible so that it may be altered when needed. It should be possible for a company to change its capital structure with minimum cost and delay if warranted by changed circumstances.

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3.) **Minimum Risk:** Capital structure should ensure minimum risk. The use of excessive debt threatens the solvency of the firm because it involves a fixed commitment to pay the interest irrespective of the profits. Debt should be used to the extent it doesn't add significant risk.

4.) **Maximum Profitability:** Capital structure of the company must provide maximum return to equity shareholders. If there is a probability of earning higher return on company's assets in comparison to the cost of debt, a large amt. of debt can be used by the firm to maximise its profitability, the firm should refrain from employing debt capital.

5.) **Retaining Control:** Capital structure should help the present management in retaining the control over the company. For this purpose debt should be preferred in comparison to issue of equity capital while raising further funds. Debt holders do not possess voting rights in company's meetings and hence cannot elect the directors of the company whereas equity shareholders posses voting rights

6) **Legal Requirements-** capital structure should fulfill all the legal requirements. Securities and exchange Board of india (SEBI) issues certain guidelines from time to time. These should be followed while designing a capital structure

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Factors affecting or determining capital structure ......

1.) **Size of the firm:-** Usually small sized firms depend on owned capital and retained earnings for their long terms funds. This is because these firms face great difficulties in raising long-term loans. However, if they are able to raise some long-term loan, it will be available at a very high rate of interest & on convinent terms.

2.) **Cost of Capital:-** The cost of different sources of capital has a vital effect on the capital structure of a firm. Different sources of capital must be combined in such a proportion that the cost of capital is minimum and degree of risk is within manageable limits. Debt is a cheaper source of finance in comparison to equity capital due to two reasons:

i) the rate of interest on debt is lower than the rate of dividend expected by equity shareholders.

ii) Interest on debt is deductible from profits while computing tax whereas the dividend is paid out of post tax profits.

3.) **Retaining Control:-** The existing management of the company does not want to lose their control over the company. Equity shareholders have a right to vote and appoint directors in the meeting of the company and hence, in case the company raises funds through issue of new equity shares there is risk of dilution of control. A group of shareholders can purchase all.

4) Credit Market Conditions :- Capital Market conditions go on changing from time to time. Sometimes there may be depression while at other times there may be boom conditions in the capital market. If the share market is depressed, the company should not issue equity shares, but issue debentures because the investors would prefer safety than profitability. On the contrary, in the boom period in the share market.

5) Nature of Investors- Investors may be classified in different categories on the basis of their outlook towards risk and returns. Some investors are of enterprising nature. They prefer to take higher risk to earn higher return and hence equity shares should be issued to meet their requirements.

6) Floation cost- Floatation cost are the costs incurred at the time of raising finance. These include underwriting commission, brokerage, cost of printing and publicity etc. Normally, the floatation cost of raising debt is lower than that of issuing the shares. This may encourag

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a company to raise debt than issue shares. But floatation costs are not a significant consideration to decide about the source of finance because floatation costs as a % of funds raised will decline with the increase in size of the share issue.

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is also low in comparison to small sized firms. Hence, a large company can employ various sources of finance and has flexibility in designing its capital structure.

(2) **Stability of Earnings :** The companies, which have regular and increasing sales and earnings may resort to higher debt, *i.e.*, high degree of leverage in their capital structure. This is because such companies will not face any difficulty in paying the interest and debts on time. On the other hand, the companies, which face frequent fluctuations in sales and earnings should not employ higher debt because they run the risk of being unable to pay the interest and the principal on time which would cause financial distress.

(3) **Degree of Competition :** If there is keen competition in an industry, the firms in that industry should use relatively a greater proportion of equity than debt. On the other hand, the industries which do not have high degree of competition will have a tendency of stable sales and therefore, the firm engaged in such type of industry can afford to use more debt.

(4) **Stage of Life Cycle of the Firm :** If a firm is in its initial stages, the chances of its failure would be high. Hence it should put more emphasis on the use of equity capital. It should avoid the use of long-term loans which require fixed payment of interest. When the firm grows and reaches maturity it may resort to long-term debts.

(5) **Interest Coverage Ratio :** This ratio measures the ratio of fixed interest payments in relation to the profitability of the business. It determines whether the company has the capacity to meet its fixed interest obligations or not. The higher the coverage ratio, the greater will be the capacity of the firm to meet its obligations of interest payment and hence more amount can be used as debt. The ratio is calculated as under :

$$\text{Interest Coverage Ratio} = \frac{\text{Profit before Interest and Income Tax}}{\text{Fixed Interest Charges}}$$

(6) **Cash Flow Ability of the Firm :** Sometimes, the interest coverage ratio of a firm is quite high but it does not have sufficient cash to pay its fixed charges in time which include payment of interest, principal and preference dividends. This may be due to the reason that the firm's income is blocked within the firm in the form of high inventory, debtors and sometimes purchase of fixed assets. Hence, whenever a company thinks of raising additional debt, it must analyse its future cash flows to meet its fixed charges. The companies which expect larger and regular cash inflows in future can use larger amount of debt in their capital structure. The capacity of the company to generate cash flows to meet its fixed charges can be examined by using the *ratio of net cash inflows to fixed charges.* The greater the ratio, the greater will be the capacity of company to use the debt.

(7) **Cost of Capital :** The cost of different sources of capital has a vital effect on the capital structure of a firm. Different sources of capital must be combined in such a proportion that the cost of capital is minimum and the degree of risk is within manageable limits. Debt is a cheaper source of finance in comparison to equity capital due to two reasons : (*i*) The rate of interest on debt is lower than the rate of dividend expected by equity shareholders, and (*ii*) Interest on debt is deductible from profits while computing tax whereas the dividend is paid out of post tax profits. Hence, debt

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is preferable to equity capital from the cost point of view. The cost of preference share capital lies between the cost of debt and the cost of equity share capital.

(8) **Rate of Corporate Tax :** Rate of corporate tax is likely to have a significant bearing on the capital structure of a company. As stated earlier, interest on debt is tax deductible whereas dividend is paid out of post tax profits. Hence, higher the rate of tax, greater will be the advantage of using debt as compared to preference and equity capital. More use of debt in the capital structure of a company helps to increase the profits available to equity shareholders. It is illustrated in the following table :

	Alternative I 11% Debentures	*Alternative II 11% Preference Share Capital*
	₹	₹
Project Outlay	10,00,000	10,00,000
Earnings Before Interest & Tax (Suppose 25% on Project Outlay)	2,50,000	2,50,000
Less : Interest on Debentures @ 11%	1,10,000	—
Earnings Before Tax	1,40,000	2,50,000
Less : Taxes (Suppose @ 45%)	63,000	1,12,500
Earnings After Tax	77,000	1,37,500
Less : Preference Dividend @ 11%	—	1,10,000
Earnings available to Equity Shareholders	77,000	27,500

Table shows that by using 11% Debentures, the earning available to equity shareholders is ₹77,000 whereas by using 11% Preference Share Capital, this earning is only ₹27,500. Hence, additional income available to equity shareholders due to income tax is ₹49,500 (*i.e.,* ₹77,000 – ₹27,500).

(9) **Retaining Control :** The existing management of the company does not want to lose their control over the company. Equity shareholders have a right to vote and appoint directors in the meeting of the company and hence, in case the company raises funds through issue of new equity shares, there is risk of dilution of control. A group of shareholders can purchase all or most of the new shares and control the company. To avoid the risk of loss of control, the companies prefer to issue preference shares or debentures because they do not have voting rights and elect the directors.

However, it should be remembered that if the company borrows more than its interest and debt repaying capacity, the lenders may seize the assets of the company to satisfy their claims. In such a case the management would lose all control. Hence, it might be better to sacrifice some control by issuing some additional equity shares rather than run the risk of losing all control by raising too much debt.

(10) **Flexibility :** Capital structure of a firm should be flexible, *i.e.,* the firm should be capable of changing its sources of funds in either direction *i.e.,* increase or decrease, in response to changes in the needs for funds. It should be capable of raising additional funds without undue delay and cost, whenever needed and it should also be able to

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decrease the funds by redeeming the preference capital and debentures when the funds are not needed. It should also be able to substitute one source of finance for another to achieve economy. For instance, if the funds are available at 14% rate of interest presently and the company has outstanding debt at 18% rate of interest, it can save interest cost if it can replace the old debt by the new debt. Preference shares and debentures offer the highest flexibility in the capital structure of a firm because they can be redeemed at the discretion of the firm.

(11) **Capital Market Conditions :** Capital market conditions go on changing from time to time. Sometimes there may be depression while at other times there may be boom conditions in the capital market. If the share market is depressed, the company should not issue equity shares, but issue debentures because the investors would prefer safety than profitability. On the contrary, in the boom period in the share market, the investors want to earn speculative incomes, and hence at such times, it will be appropriate to raise funds by issue of equity shares even at high premium.

(12) **Credit Standing of the Firm :** Firms which enjoy high credit standing from the viewpoint of investors and lenders in the capital market are in an advantageous position to raise finance on easy terms and from the sources of their choice. But in case the firm's credit standing is poor, the firm will not be able to get finance from the source of its choice.

(13) **Trading on Equity :** The use of fixed cost sources of finance, such as debts and preference share capital is termed as trading on equity or financial leverage. In case the assets acquired from the debt funds yield a return greater than the cost of debts, the profits available to equity shareholders or the earning per share (EPS) will increase. EPS will also increase by the use of preference share capital but it will increase more in case of use of debt because the interest paid on debt is deductible from profits while calculating the tax. Hence, the alternative methods of financing must be analysed by the management to examine their effect on EPS. To illustrate :

Suppose that a firm has an all-equity capital structure consisting of 2,00,000 equity shares of ₹10 each. The firm now desires to raise ₹5,00,000 to acquire additional assets and is considering three alternative methods of financing : (*i*) to issue 50,000 equity shares of ₹10 each, or (*ii*) to raise a debt of ₹5,00,000 at 12% rate of interest, or (*iii*) to issue 5,000 preference shares of ₹100 each at 12% rate of dividend. If the firm's earnings before interest and taxes after additional assets are acquired are ₹8,00,000 and the tax rate is 40%, the effect on the earning per share under the three alternatives will be as follows :

	Equity Financing	*Debt Financing*	*Preference Capital Financing*
	₹	₹	₹
Earnings Before Interest & Tax	8,00,000	8,00,000	8,00,000
Less : Interest	—	60,000	—
Earnings Before Tax	8,00,000	7,40,000	8,00,000
Less : Taxes @ 40%	3,20,000	2,96,000	3,20,000

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Earnings After Tax	4,80,000	4,44,000	4,80,000
Less : Preference Dividend	—	—	60,000
Earnings available to Equity Shareholders	4,80,000	4,44,000	4,20,000
Number of Equity Shares Outstanding	2,50,000	2,00,000	2,00,000
Earning Per Share (EPS)	1.92	2.22	2.1

It is clear from the above example that the firm will be able to maximise its EPS when it uses debt financing. But the debt financing will have an adverse effect on EPS if the company is not able to earn a rate of return on its assets greater than the interest rate on debt.

(14) **Legal Requirements :** The Government issues guidelines for the issue of shares and debentures from time to time. While designing its capital structure, the firm should consider these guidelines and also the relevant provisions of different laws framed by the Government. In addition, it should also take into consideration the rules framed by Securities and Exchange Board of India (SEBI), the stock exchanges and the norms set by financial institutions from time to time.

(15) **Flotation Costs :** Flotation costs are the costs incurred at the time of raising finance. These include underwriting commission, brokerage, cost of printing and publicity etc. Normally, the flotation cost of raising debt is lower than that of issuing the shares. This may encourage a company to raise debt than issue shares. But flotation costs are not a significant consideration to decide about the source of finance because flotation costs as a percentage of funds raised will decline with the increase in size of the share issue.

(16) **Leverage Ratios for other Firms in the Industry :** While making capital structure decisions, the debt equity ratio of the firm should be compared with the debt equity ratios of other firms belonging to the same industry, having a similar business risk. If the debt equity ratio of a particular firm is different than the industry standard, it acts as a warning to the management and the management should ascertain the reasons for the deviation.

(17) **Nature of Investors :** Investors may be classified in different categories on the basis of their outlook towards risk and return. Some investors are of enterprising nature. They prefer to take higher risk to earn higher return and hence equity shares should be issued to meet their requirements. On the other hand, some investors are of conservative nature. They do not want to take higher risk and are satisfied with lower return and hence debentures of preference shares should be issued to meet their requirements.

(18) **Consultation with Investment Bankers and Lenders :** While determining the proportion of various securities in a firm's capital structure, it is very useful to seek the opinion of institutional investors, investment bankers and lenders. They possess information about the capital structure of large number of companies and know as to the demand of various securities in the capital market. Hence, their opinion can be very useful while taking a decision about the capital structure. Similarly, prospective lenders and investors should also be consulted because it is they who will ultimately

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provide finances to the company. The type of securities which they will prefer to invest is very important information for the company.

(19) **Attitude of Management :** Lastly, the attitude of the management towards all the factors discussed above will finally determine the capital structure of the firm. Management of various firms differ in skills, judgement and experience. Some managements are enterprising and they are prepared to take higher risk to reduce the cost of capital. Such managements do not hesitate to use more of debt in their capital structure. On the other hand, some managements are conservative and they do not want to take high risk. They prefer the use of more amount of equity capital in comparison to debt.

The above factors must be considered while designing an optimum capital structure of a company. However, these factors do not yield an optimum capital structure by themselves because some of these factors are conflicting in nature. For example, the debt is a cheaper source of finance and hence a company should use more amount of debt to reduce the cost of capital but the enlarged use of debt increases the risk and hence the company cannot use more amount of debt. Moreover, it should be remembered that :

'Financial theory has not developed to the point where data related to these considerations are fed at one end of a computer and an ideal financial structure pops out of the other. Consequently, human judgement must be used to resolve the many conflicting forces in laying plans for the types of funds to be sought.'

— *R.W. Johnson*

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factors affecting Working capital or Determinants of Working capital and Issues of Working Capital Management?

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Factors affecting Working Capital
Or
Determinants of Working Capital

A firm should have neither too much nor too little working capital. The working capital requirement is determined by a large number of factors but, in general, the following factors influence the working capital needs of an enterprise :

(1) **Nature of Business** : Working Capital requirements of an enterprise are largely influenced by the nature of its business. For instance, public utilities such as railways, transport, water, electricity etc. have a very limited need for working capital because they have to invest fairly large amounts in fixed assets. Their working capital need is minimal because they get immediate payment for their services and do not have to maintain big inventories. On the other extreme are the trading and financial enterprises which have to invest less amount in fixed assets and a large amount in working capital. This is so because the nature of their business is such that they have to maintain a sufficient amount of cash, inventories and debtors. Working capital needs of most of the manufacturing enterprises fall between these two extremes, that is, between public utilities and trading concerns.

(2) **Size of Business** : Larger the size of the business enterprise, greater would be the need for working capital. The size of a business may be measured in terms of scale of its business operations.

(3) **Growth and Expansion** : As a business enterprise grows, it is logical to expect that a larger amount of working capital will be required. Growing industries require more working capital than those that are static.

(4) **Production Cycle** : Production cycle means the time-span between the purchase of raw materials and its conversion into finished goods. The longer the production cycle, the larger will be the need for working capital because the funds will be tied up for a longer period in work in process. If the production cycle is small, the need for working capital will also be small.

(5) **Business Fluctuations** : Business fluctuations may be in the direction of boom and depression. During boom period the firm will have to operate at full capacity to meet the increased demand which in turn, leads to increase in the level of inventories and book debts. Hence, the need for working capital in boom conditions is bound to increase. The depression phase of business fluctuations has exactly an opposite effect on the level of working capital requirement.

(6) **Production Policy** : The need for working capial is also determined by production policy. The demand for certain products (such as woolen garments) is seasonal. Two types of production policies may be adopted for such products. Firstly, the goods may be produced in the months of demand and secondly, the goods may be produced throughout the year. If the second alternative is adopted, the stock of finished goods will accumulate progressively upto the season of demand which requires an increasing amount of working capital that remains tied up in the stock of finished goods for some months.

(7) **Credit Policy Relating to Sales** : If a firm adopts liberal credit policy in respect of sales, the amount tied up in debtors will also be higher. Obviously, higher

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book debts mean more working capital. On the other hand, if the firms follows tight credit policy, the magnitude of working capital will decrease.

(8) **Credit Policy Relating to Purchase** — If a firm purchases more goods on credit, the requirement for working capital will be less. In other words, if liberal credit terms are available from the suppliers of goods (*i.e.*, creditors), the requirement for working capital will be reduced and vice versa.

(9) **Availability of Raw Material** : If the raw material required by the firm is available easily on a continuous basis, there will be no need to keep a large inventory of such materials and hence the requirement of working capital will be less. On the other hand, if the supply of raw material is irregular, the firm will be compelled to keep an excessive inventory of such materials which will result in high level of working capital. Also, some raw materials are available only during a particular season such as oil seeds, cotton, etc. They would have to be necessarily purchased in that season and have to be kept in stock for a period when supplies are lean. This will require more working capital.

(10) **Availability of Credit from Banks** : If a firm can get easy bank credit facility in case of need, it will operate with less working capital. On the other hand, if such facility is not available, it will have to keep large amount of working capital.

(11) **Volume of Profit** : The net profit is a source of working capital to the extent it has been earned in cash. Higher net profit would generate more internal funds thereby contributing the working capital pool.

(12) **Level of Taxes** : Full amount of cash profit is not available for working capital purposes. Taxes have to be paid out of profits. Higher the amount of taxes less will be the profits available for working capital.

(13) **Dividend Policy** : Dividend policy is a significant element in determining the level of working capital in an enterprise. The payment of dividend reduces the cash and, thereby, affects the working capital to that extent. On the contrary, if the company does not pay dividend but retains the profits, more would be the contribution of profits towards working capital pool.

(14) **Depreciation Policy** : Although depreciation does not result in outflow of cash, it affects the working capital indirectly. In the first place, since depreciation is allowable expenditure in calculating net profits, it affects the tax liability. Higher rates of depreciation reduce the profits and, therefore reduce the tax liability. In the second place, higher depreciation also means lower disposable profits and, in turn, a lower dividend payment. Thus, outgo of cash is restricted to that extent.

(15) **Price Level Changes** : Changes in price level also affects the working capital requirements. If the price level is rising, more funds will be required to maintain the existing level of production.

(16) **Efficiency of Management** : Efficiency of management is also a significant factor to determine the level of working capital. Management can reduce the need for working capital by the efficient utilisation of resources. It can accelerate the pace of cash cycle and thereby use the same amount working capital again and again very quickly.

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Two Major Issues in Formulating Working Capital Policy | Financial Management

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1. Current assets in relation to sales:

If the firm can forecast accurately its level and pattern of sales, inventory procurement time, inventory usage rates, level and pattern of production, production cycle time, split between cash sales and credit sales, collection period, and other factors which impinge on working capital components, the investment in current assets can be defined uniquely.

In case of uncertainty, the outlay on current assets would consist of a basic component meant to meet normal requirements and a safety component meant to cope with unusual demands and requirements. The safety component depends on how conservative or aggressive is the current ' asset policy of the firm. If the firm pursues very conservative current asset policy it would carry a high level of current assets in relation to sales. (This happens because the safety Component is substantial).

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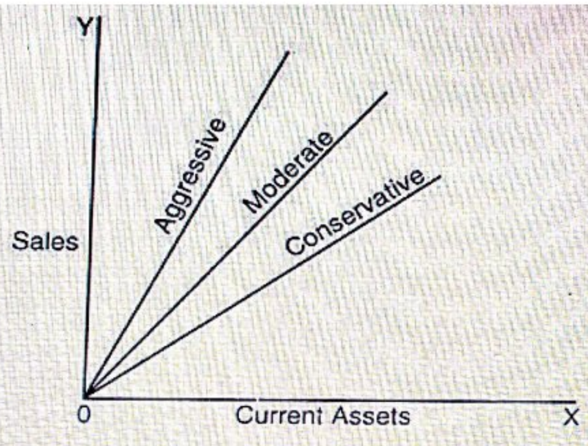

If the firm adopts a moderate current asset policy, it would carry a moderate level of current assets in relation to sales. Finally, if the firm follows a highly aggressive current asset policy, it would carry a low level of current assets in relation to sales. The relationship between current assets and sales under these different current asset policies is shown in the above figure.

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A conservative current asset policy tends to reduce risk. The surplus current assets under this policy enable the firm to cope rather easily with variations in sales, production plans, and procurement time. Further, the higher liquidity associated with this policy diminishes the chances of technical insolvency. The reduction of risk, however, is also accompanied by lower expected profitability.

An aggressive current asset policy, seeking to minimise the investment in current assets exposes the firm to greater risk. The firm may be unable to cope with unanticipated changes in the market place and operating conditions. Further, the risk of technical insolvency becomes greater. The compensation for higher risk, of course, is higher expected profitability.

2. Ratio of Short-Term Financing to Long- Term Financing:

Current assets of a firm are supported by spontaneous current liabilities (Trade creditors and provisions), short- term bank financing, and long-term sources of finance (debentures and equity, in the main). Assuming that the level of spontaneous current liabilities is determined by extraneous factors (trade practice, income-tax payment schedule, etc.) the relevant question in current asset financing is what should be the relative proportions of short- term bank financing on the one hand, and long-term sources of finance, on the other?

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The two broad policy alternatives in this respect are:

(i) a conservative current asset financing policy, and

(ii) an aggressive current asset financing policy.

A conservative current asset financing policy relies less on short-term bank financing and more on long-term sources like debentures. Indeed, a highly conservative current asset financing policy would seek to replace even long-term debt by equity. An aggressive current asset financing policy, on the other hand, relies heavily on short- term bank finance and seeks to reduce dependence on long-term financing.

A conservative current asset financing policy reduces the risk that the firm will be unable to repay or replace its short-term debt periodically. It, however, enhances the cost of financing because the long-term sources of finance, debt and equity, have a higher cost-associated with them.

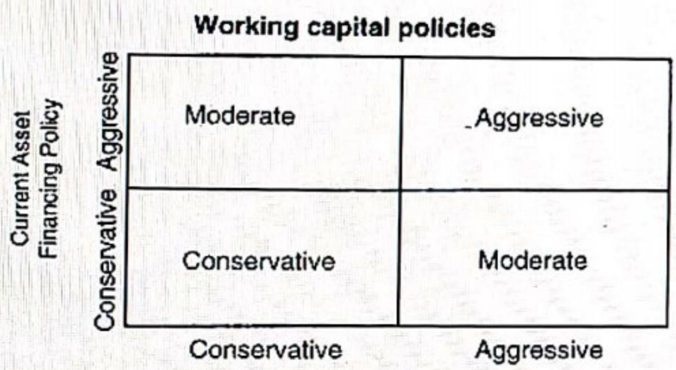
An aggressive current asset policy, relying more on short-term bank financing, tends to have the opposite effects. It exposes the firm to a hinder degree of risk, but reduces the average cost of financing.

Choosing the working capital policy:

The overall working capital policy adopted by the firm may broadly be conservative, moderate or aggressive. A conservative overall working capital policy means that the firm chooses a conservative current asset policy along with a conservative current asset financing policy.

A moderate overall working capital policy reflects a combination of a conservative current asset policy and an aggressive current asset financing policy or a combination of an aggressive current asset policy and a conservative current asset financing policy.

An aggressive overall working capital policy consists of an aggressive current asset policy and an aggressive current asset financing policy. The following figure shows visually the various ways of combining individual policies, with respect to current assets and current assets financing, into an overall working capital policy.



An overall conservative working capital policy reduces risk and offers low return. An overall moderate working capital policy offers moderate return accompanied with moderate risk. An overall aggressive working capital policy provides a package of high risk and high return. The choice of an overall working capital policy would depend on the risk disposition of

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Meaning of Cash Management? Motives of holding Cash and problems of Cash Management?

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11

Management of Cash

The main objective of Working Capital management, as discussed in the previous chapter, is the efficient management of each component of current assets. For this purpose the optimum level of investment in each of the current assets is determined. Management of Cash has been explained in this chapter whereas the management of Receivables and management of Inventory will be explained in the succeeding chapters.

Cash is the most liquid current asset. All other current assets such as receivables and inventory ultimately get converted into cash. Therefore, business should keep optimal cash balance at every point of time. It should neither be in excess nor short of its requirements.

The term Management of Cash includes :

(a) Determination of optimum amount of cash required in the business.

(b) Keep the cash balance at optimum level and investment of surplus cash in profitable manner.

(c) Prompt collection of cash from receivables (*i.e.,* from debtors and bills receivables) and efficient disbursement of cash.

Meaning of Cash

For the purpose of cash management, the term cash not only includes coins, currency notes, cheques, bank drafts, demand deposits with banks but also the 'near-cash assets' like marketable securities and time deposits with banks because they can be readily converted into cash. For the purpose of cash management, near-cash assets are also included under cash because surplus cash is required to be invested in near-cash assets for the time being.

Motives of Holding Cash

In every business assets are kept because they generate profit. But cash is an asset which does not generate any profit itself, yet in every business sufficient cash balance is maintained. There are four primary motives or causes for maintaining cash balances:

(i) Transaction Motive

(ii) Precautionary Motive

(iii) Speculative Motive; and

(iv) Compensating Motive

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(*i*) **Transaction Motive :** A number of transactions take place in every business. Some transactions result in cash outflow such as payment for purchases, wages, operating expenses, financial charges like interest, taxes, dividends etc. Similarly, some transactions result in cash inflow such as receipt from sales, receipt from investments, other incomes etc. But the cash outlfows and inflows do not perfectly match with each other. At times, inflows exceed outflows while, at other times outflows exceed inflows. To meet the shortage of cash in situation when cash outflows exceed cash inflows, the business must have an adequate cash balance.

(*ii*) **Precautionary Motive :** In every business, some cash balance is kept as a percautionary measure to meet any unexpected contingency. These contingencies may include the following :

(*a*) Floods, strikes and failure of important customers.

(*b*) Unexpected slow down in collection from debtors.

(*c*) Cancellation of orders by customers.

(*d*) Sharp increase in cost of raw-materials.

(*e*) Increase in operating costs etc.

(*iii*) **Speculative Motive :** In business, some cash is kept in reserve to take advantage of profitable opportunities which may arise from time to time. These opportunities are :

(*a*) Opportunity to purchase raw material at low prices on payment of immediate cash.

(*b*) Opportunity to purchase securities when their prices are low.

(*c*) Opportunity to purchase other assets for the business when their prices are low.

(*iv*) **Compensating Motive :** Banks provide a number of services to the business such as clearance of cheques, supply of credit information about other customers, transfer of funds and so on. Banks charge commission or fee for some of these services. For other services, banks do not charge commission or fee but they require indirect compensation. For this purpose, banks require the clients to maintain a minimum balance in their accounts in the bank. The clients cannot use this bank balance and banks compensate the cost of providing free services by using this amount to earn a return. Therefore, cash is also kept at the bank to compensate for free services by banks to the business.

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5 Major Cash Management Challenges in Business & How to Deal with That?

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Currently, despite a significant increase in non-cash payment technologies, cash remains one of the main means of payments for different business organizations, start-up companies, MNC's and individual business owners. Cash management is one of the main aspects of managing a company's current business as the availability of sufficient cash in accounts for daily business operations & timely settlement of different utility bills.

Companies face several problems when they have to manage the cash in and out of the company and maintain strict financial discipline. So, here a list of the top 5 cash management challenges in business & effective tips to deal with that.

Difficulty to Deal with Cash Flow

If you do not plan the cash flow of your company, then you cannot predict cash gaps. This leads to the fact that at the end of the month you do not have money to pay the bill. Due to the lack of a cash flow management system, you cannot be sure that the same situation will not happen next month. As a result, this can ruin relationships, break an established supply chain, and hence deteriorate customer relationships.

Solution

The solution to this problem is using E-Invoicing Software. E-invoicing offers a transparent work architecture. It makes each and every part of the financial process visible to the buyers and suppliers. By removing the human error element from the equation, this system offers fast and safe-to-trust solutions. In this way, the buyers see the opportunity of getting discounts, thus adding more to the cash flow.

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Difficult to Make Settlements in Different Currencies

In many organizations, It is tough to make the settlements or transactions in different currencies. There are many organizations that have their branches in different countries. But the problems occur when they evaluate the dollars in euros or in other currency. It is a lengthy process for making the conversion of one currency into others.

Solution

The **invoicing software** is one of the best solutions for this. By automating your business transactions through this software, you will always save time, which engages you in other activities. While making the transactions, the system will easily convert the dollars into euros on any other currency without taking the time. This way buyers will easily get to paid without waiting for a long time in the queue. The system is able to handle the different currencies of different countries. So, this makes the easy process in cash flow management.

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o Major Issues in Formulating × Cash Management Problems in E × +

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Generation of Poor Planning Management

Days of sales of outstanding measures, how quickly the company collects cash from customers. This metric is calculated by multiplying the number of days in a period by the ratio of receivables to credit sales for the period. If the volume of sales days issued grows, this indicates a poor collection of receivables. This leads to an increase in current assets, which is the use of cash that reduces cash flows from operating activities.

Solution

As you know the business needs planning and methods to stay ahead in competitions. So, for that, you need comprehensive data on your cash flow, which is possible through management software. This way you can evaluate when and how much money is coming, how much you have to spend, and how much you can spare for new ventures. The system will automate your finances and access important data like payment arrival, new order confirmation, and another supplier information instantly.

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Consolidated Financial Reporting in a Fiscal Year

In the end, every company calculates their net profit and loss of the year by measuring the products price, plus product purchasing. But, manually, it becomes a little bit tough to manage the balance sheet. There may be an error in the calculation or you may be forgot something to include in your balance sheet. And, due to this, where you want to get profit, maybe, you fall in a big loss. So, all these aspects make a great impact on cash flow management.

Solution

If you want the business to bring money, then constantly look at the bottom line of the balance sheet, considering the benefits and disadvantages of any individual costs. After all, every dollar spent is ultimately taken from your profit. In this, e-invoicing automates the calculation, where it can easily manage all the assets and liabilities of the sheets. This automatically reduces the occurrence of an error in your sheet and you will able to generate the correct financial reporting.

Inconvenience in Tracking the Business Expenses

In a small and large organization, it is quite tough to track the expenses like payments, transactions, and other expenditures. These things make a great impact on your balance sheet. How much you spend, where you used the earning money and how much material you buy? Avoiding these things means a huge loss in business profits.

Solution

You can easily track your expense records with complete visibility on the invoicing process. The detailed digital reports of this **invoice management system** can make information analysis easy. By isolating the components quickly, you can channelize the fund where it is needed. This means better management will help to make better business decisions.

Final Words

Managing cash flow correctly means increasing the chances for a small business to succeed. Without any doubt, a lot of business transactions are made in cash all over the world. Business organizations need to cope with major challenges in cash arrangements to strengthen their finances & keep making progress every day. Good Luck!

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