Financial Management

Introduction to Financial Management

1. The financial goal of any firm is to maximise the wealth of the shareholders by maximising the value of the firm.
2. The objective of financial manager is to increase or maximise the wealth of the shareholders by maximising the value of the firm which is reflected in its earning per share and market value of the firm.
3. Function of finance manager includes mobilisation of funds, deployment of funds, control over the use of fund, and balancing the trade-off between risk and return.
4. advantages of sole proprietorship are:
   a. easy and inexpensive setup
   b. few governmental regulations and
   c. No firm tax.
2. Partnership firm is a business owned by two or more persons. They r partners in business and they bear the risks and reap the rewards of the business. A partnership firm is governed by Indian Partnership Act, 1932. Hence it is relatively free from governmental regulations as compared to the joint stock companies.
3. A group of persons working towards a common objective is a company.
4. Corporate investment and financing decisions are circumscribed by a government regulatory framework. The imp elements of these framework are:
   a. Industrial Policy
   b. Industrial Licensing Provisions and Procedure
   c. Regulation of foreign Collaborations and Investment
   d. Foreign Exchange Management Act (FEMA)
   e. Monopolies and Restrictive Trade Practice Act
   f. Companies Act, and
   g. SEBI

Indian Financial System

1. The role of the financial sector can be broadly classified into the savings function, policy function and credit function.
2. The main types of financial markets are: money market, capital market, forex market and credit market.
3. A market is considered perfect if all the players are price takers, there are no significant regulations on the transfer of funds and transaction costs, if any, are very low.
4. The main financial intermediaries are stock exchanges, investment bankers, underwriters, registrars, depositories, custodians, primary dealers, satellite dealers and forex dealers.

Time value of money

1. Annuity is the term used to describe a series of periodic flows of equal amounts.
2. Under the method of compounding, we find the Future Values (FV) of all the cash flows at the end of the time horizon at a particular rate of interest.
3. Under the method of discounting, we reckon the time value of money now i.e., at time zero on the time line. So, we will be comparing the initial outflow with the sum of the present values (PV) of the future inflows at a given rate of interest.

Risk and Return

1. The most common measures of riskiness of security are standard deviation and variance of returns.
2. Unsystematic risk is the extent of the variability in the security's return on account of the firm specific risk factors. This is also called diversifiable or avoidable risk factors. It is the variance unexplained by the index.
3. Systematic risk refers to factors which affect the entire market and hence the firm too. This is also k/a non-diversifiable risk. It is the variance explained by the index.
4. Security Market Line (SML) represents the avg or normal trade-off between risk and return for a group of securities.
5. The ex post SML is used to evaluate the performance of portfolio manager, tests of asset-pricing theories, such as CAPM and to conduct tests of market efficiency.
6. The ex ante SML is used to identify undervalued securities and determine the consensus, price of risk implicit in the current market prices.
7. Depending upon the value of alpha, using SML it is possible to estimate whether the scrip is under-priced or over-priced.

Leverage

1. Leverage is the influence which an independent financial variable has over a dependent / related financial variable.
2. The financial leverage measures the effect of the change in EBIT on the EPS of the company. Financial leverage refers to the mix of debt and equity in the capital structure of the company. The measure of financial leverage is the Degree of Financial Leverage (DFL).

Valuation of Securities

1. Value of any security can be defined as the PV of the future cash streams. i.e. the intrinsic value of an asset should be equated to the PV of the benefits associated with it.
2. Book value is an accounting concept. Assets are recorded at historical costs and they are depreciated over years. Book value includes intangible assets at acquisition cost minus amortized value. The book value of debt is stated at the outstanding amount. The difference between the book value of assets and liabilities is equal to shareholder's funds or net worth which is equal to paid-up equity capital plus reserves and surplus.
3. Replacement value is the amount that a company would be required to spend if it were to replace its existing assets in the current condition.
4. Liquidation value is the amount that a company could realize if it sells its assets after having terminated its business.
5. Going concern value is the amount that a company could realize if it sells its business as an operating one. Its value would always be higher than the liquidation value.
6. Market value of an asset or security is the current price at which the asset or the security is being sold or bought in the market.
7. Redemption value: which a bond holder gets on maturity. A bond may be redeemed at par, at premium or at discount.
8. Coupon rate and current yield are two different measures. Coupon rate and current yield will be equal if the bond's market price equals its face value.
9. Yield-To-Maturity (YTM): it is the rate of return earned by an investor who purchases a bond and holds it till maturity. The YTM is the discount rate which equals the PV of promised cash flows to the current market price / purchase price.
10. When the required rate of return (Kd) is greater than the coupon rate, the value of the bond is less than its par value. i.e., if Kd > coupon rate; then value of a bond < par value.

11. When the required rate of return (Kd) is greater than the coupon rate, the discount on the bond declines as maturity approaches.
12. When the required rate of return (Kd) is less than the coupon rate, the premium on the bond declines as maturity approaches.
13. A bond's price is inversely proportional to it YTM.
14. A warrant is a call option to buy a stated number of shares.
15. Intrinsic value is the value of a stock which is justified by assets, earnings, dividends, definite prospects and the factor of the management of the issuing company.

Sources of Long-term Finance

1. Firms can issue three types of capital. Equity, preference and debenture capital. These distinguish amongst themselves in the risk, return and ownership pattern.
2. Preference shares have some attributes similar to equity shares and some to debentures. Like in the case of equity shareholders, there is no obligatory payment to them and the preference dividend is not tax-deductible.
3. Preference shares can be of two types:
   a. Cumulative or Non-Cumulative preference shares.
   b. Redeemable or perpetual preference shares.
4. For cumulative preference shares the dividends will be paid on a cumulative basis, in case they remain unpaid in any financial year due to insufficient profits. The company will have to pay up all the arrears of preference dividends before declaring any equity dividends.
5. A debenture is a marketable legal contract whereby the company promises to pay its owner, a specified rate of interest for a defined period of time and to repay the principal at the specific date of maturity.
6. Debentures are usually secured by a charge on the immovable properties of the company.
7. If the company issues debentures with a maturity period of more than 18 months, then it has to create a Debenture Redemption Reserve (DRR), which should be at least half of the issue amount before the redemption commences.
8. Debentures can be classified based on the conversion and security:
   a. Non-Convertible Debentures (NCD)
   b. Fully-Convertible Debentures (FCD)
   c. Partially-Convertible Debentures (PCD)
   d. Secured Premium Notes (SPNs): This is a kind of NCD with an attached warrant.
9. Under section 81 of the Companies Act, 1956, when a firm issues additional equity capital, it has to first offer such securities to the existing shareholders on a pro-rate basis k/a rights issue.
10. Buy-out is a process where by an investor or a group of investors buy-out a significant portion of the equity of an unlisted company with a view to take it public within an agreed time frame.
11. Bill rediscounting, supplier's line of credit, seed capital assistance and risk capital foundation schemes are examples of deferred credit schemes.
12. Hire purchase is a contractual agreement similar to lease where the ownership will be transferred to the buyer after all the hire purchase instalments are paid-up.

Cost of Capital and Capital Structure Theories

1. The cost of capital to a company is the min rate of return that it must earn on its investments in order to satisfy the various categories of investors who have made investments in the form of shares, debentures or term loans.
2. A company's cost of capital is weighted arithmetic average of the cost of the various sources of finance that have been used by it.
3. The cost of a debenture is defined as the discount rate which equates the net proceeds from issue of debentures to the expected cash outflows in the form of interest and principal repayments.

4. The cost of terms loan will be interest rate multiplied by (1-Tax rate). The interest is multiplied by (1-Tax rate) as interest on term loans is also tax deductible.
5. The cost of a redeemable preference share (Kp) is that discount rate which equates the proceeds from preference capital issue to the payments associated with the same. i.e. dividend payment and principal payment.
6. According to the dividend forecast approach, the intrinsic value of an equity stock is equal to the sum of the PVs of the dividends associated with it.
7. Realized Yield Approach: the past returns on a security are taken as a proxy for the return required in the future by the investors.
8. Bond Yield Plus Risk Premium Approach: The logic behind this approach is that the return required by the investors is directly based on the risk profile of the company. This risk profile is adequately reflected in the return earned by the bondholders. Yet, since the risk borne by the equity investors in higher than that of bondholders, the return earned by them should also be higher.
9. Earning price ratio approach: the cost of equity calculated as E1/P where E1= Expected EPS for the next year, P = Current market price per shares. E1 can be arrived by multiplying the current EPS by (1+ growth rate).
10. The capital structure of a company refers to the mix of the long-term finances used by the firm. It is the financing plan of the company.
11. Net Income Approach: the cost of equity capital (Ke) and the cost of debt capital (Kd) remain unchanged when B/S, the degree of leverage varies.
12. Net Operating Income Approach: the overall capitalization rate and the cost of debt remain constant for all degree of leverage.

Dividend Policy

1. Traditional approach by B Graham and DL Dodd: The stock value responds +ly to higher dividends and –ly when there are low dividends.
2. Traditional approach states that P/E ratios are directly related to the dividend pay-out ratios.
3. Dividend policy by James E Walter also considers that dividends are relevant and they do affect the share price. According to him:
   a. When the ROI is more than the cost of equity capital, the earnings can be retained by the firm since it has better and more profitable investment opportunities than the investors.
   b. When the ROI is less than the cost of equity capital, all the earnings should be paid to the investors.
4. Gordon's Model assumes that the investors are rational and risk-averse. They prefer certain returns to uncertain returns and thus put a premium to the certain returns. Thus, investors would prefer current dividends and avoid risk.
5. Miller and Modigliani have propounded the MM hypothesis to explain the irrelevance of the firm's dividend policy. According to this model, it is only firms' investment policy that will have an impact on the share value of the firm and hence should be given more importance.
6. According to the rational expectations model, there would be no impact of the dividend declaration on the market price of the share as long as it is at the expected rate.