Course Name: Business Fundamentals for Entrepreneurs – Part 1 – Internal Operations

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Lecture – 07

Week 4 Module 7 Part 2

Okay, so that was about accounting, which is about collecting data, reporting the data etc. But you still have to manage the company's finances. That's called financial management. And what is financial management? Financial management is all about effective planning, how much money the company needs, raising the money, spending the money, and controlling it to maximize the profits and the returns on the company, on the investment that the company is making. And these are typically done by finance managers. They can be called a chief financial officer, a VP finance, finance manager, finance analyst, etc.

And they will seek to do multiple things related to the finance of a company, maximize profits, track the cash flow, also ensure compliance with the internet plans, also the external legal requirements. They'll recommend, spend money here, don't spend money there. They'll identify risk. That company is going bankrupt, or that division, or that product, or that branch is not making money.

And they'll manage relationships within the company and outside the company, the investors, the bank, the shareholders. But for startups in a very early stage, the focus will primarily be A, on making sure that I have a good business plan and I'm sticking to it, and B, getting the liquidity, which means the funds and the cash, to keep the business running. But every entrepreneur needs to know at least the basics of financial management. So let's look at what are the aspects of financial management. First, you have to make a budget.

So, if I'm selling tea, I need to know how many cups of tea will I sell tomorrow. Is this just one cup, five cups, ten cups, ten thousand cups? What will be my cost? So the budget. And then I have to calculate, to make those cups of tea, how much capital do I need to buy my milk, sugar, and tea. And for L&T, a large company like L&T, who are selling 150,000 crores and buying raw material maybe of tens of thousands of crores, they have to get the capital and then spend the capital. So make the plan, get the capital, spend the capital, put the plan.

And then there's controlling. I have to spend money as per my budget. If I spent milk, sugar, and tea in a certain proportion, it has to be per my budget. I cannot buy too much of milk and no sugar. I'll be out of business because I can't make the tea.

So, you have to control within the company how the money is being spent. And then, you have to calculate the return on the capital. That I put in money in this business, this business is all about money, am I getting a return on my capital? So if I'm making a cup of tea, I sell it at 100, but I've invested 80 rupees in the raw material; I make a profit of 20 rupees, so my return on investment is 20 rupee profit on an 80 rupee capital. So, let's look at it step by step. What is budgeting? Clearly, you have to budget and plan the income the sales, and that will come from the sales function or the marketing function.

You have to budget the cost and the expenses, and it comes from various sources, from the plants, from the factories, from the service centers, from the restaurants if you're in a restaurant business, or the people managers if you're doing people services, the expenses. You also have to budget for the capital. I have to buy a new machinery, new PCs or laptops if you're in IT service, a new warehouse, a new piece of land. So those are the capital. And you have to do it in cycles.

You have to do it every week, every month, and every year. You cannot say, okay, I'll not do it this year; I'll do it next year. You may go broke; you may run out of money. And I'll do a case study later on. That's for the actual budgeting.

So, how do you raise money? When I'm making a cup of tea, I can take money, raise money by taking a loan from the grocery store and say, I'm taking the milk, sugar and tea today, I'll pay you tomorrow. That's a loan for one day. And by the same token, sources of capital can be internal, where the company is selling its product or services. So, it's an internal source of capital. It could be external when it borrows from the bank or sells shares to its shareholders.

Or it could be a grant. A lot of not-for-profits or even educational institutes or government organizations actually get grants from the government or from the United Nations or from a foundation. So these are the sources of capital. Now let's look at how capital is deployed. First is organic growth.

I sell one cup of tea today, I sell ten cups of tea tomorrow, I sell a thousand cups of tea later. For that I need more raw material. But it's the same business. That's called organic growth. Inorganic growth is when I buy a new source of business.

Let's say now after a year I'm selling ten thousand cups of tea. And I'm making good money. Now next door there's a coffee shop. And I say I buy that coffee shop. And then I get extra revenues but I have to spend some money to buy that coffee shop.

That's inorganic growth. So companies will read or buy other companies or other lines of business. It's very common. And that's inorganic growth. So I can grow organically and use the money.

I can go and buy a new business or a new company. And that's inorganic growth. And the third option I have with capital is I'm making a lot of money, I give it back to the owners as what is called a dividend. Or I can do other forms which I'll not get into details like buying back of shares. But in essence I'm not putting it back in the business, I'm giving it back to the owners. So, these are three ways you deploy capital. Now, we come to the very important concept of return on capital. Remember again to recap and keep it simple. One cup of tea, sell it hundred rupees, raw material 80 rupees. I've taken a loan of 80 rupees.

I've got 80 rupees invested in my business. I earn a profit of 20 rupees and the return on capital is 20 divided by 80 which is 25 percent. Because my capital was 80 and I've earned a profit of 20, and the return on capital is 25 percent. So that's basically what return on capital is. ROCE is the standard term; it's called return on capital employed.

There can be other versions of return but in general if the return is higher the company is more profitable. And if the return keeps going up, up and up it becomes a very good company to invest in. And investors and any of you who are in the share market and buy publicly listed stocks from the share market will know that people who are buying stocks wants to invest in companies which have got rising returns on capital. And it's not very volatile and it's not declining which means the company is doing well. And there are certain other measures of returns.

One could be return on equity. The difference between capital and equity is equity is the money put in by the owners, the shareholders of the company but capital could also include loans. It could also be return on assets. It could be for the whole business or for a factory. I've spent one crore rupees or one million dollars in this factory. What am I getting a return on this factory? So that's return on assets.

So simply put it's a ratio and I give an example and you can see it. Any return on top operating profits capital employed into 100 as a percent. So if your operating profit is 20 and capital employed is 100, you make a return of 20 percent. Before we go to the case study, the last aspect of financial management is controlling. You need to make sure that money is being spent the way it should be spent.

Also, simple things like if you have been sold to the customer the money is being collected from the customer. And if you have bought material from the suppliers the company is paying back to the suppliers. So controlling function basically look at the financial goals. It could be very simple for a small company. It was very complex for a very large company.

Then, they set up the processes. They make sure the reports are generated on time and accurately. If there's a large variance that this was the budget but actually is different, why is there a gap? They do the gap analysis. And the controlling function will also look at compliance because (of) the legal compliance. Reports to be filed with the government. Returns to be filed with the income tax authorities or the GST authorities etc.

So, compliance comes in many different ways. So all of this makes sure that a large company financially is working well and that's also financial management. Let's continue with the mini case study of a very large company. Again, I encourage you to go to the website.

The link is there. But if you were to take the investor presentation you will find that lot of ratios are there in the investor presentation. And right at the bottom is a return number which is called return on equity in this case. They've used a term called return on equity, which is the return on the money that the shareholders have kept excluding the loans and so on.

And you'll find that it's 12.2 percent. The ROE trailing 12 months which means for the past 12 months is 12.2 percent. So this is how companies report their indicators, including returns. And if you look at slightly more deeply before we get to the financial numbers these are the segments that L&T works in.

And remember it's a very large company. There are many different segments. Just like if I start with one cup of tea over time I can have tea, I can have coffee, I can have biscuits, I can have sandwiches and so on. Over time a company will expand. So, L&T has all of these segments called infrastructure projects, energy projects, IT services, others, high tech manufacturing, financial service and development projects.

So, these are the segments. And they'll report the ratios. So, if you look at segment wise on top, you'll see P&L, which are the segments and then you see the ratios, the return ratios. Like I explained, return on capital. So if you look at it segment result divided by segment funds which means the fund that was invested in the segment versus the profits that the segment earned and you can see those ratios. And you can see which is doing well, which is not doing well.

So, this is the ultimate test of a financial management, well-managed financial company. If it generates a good return on the investment. Continuing with a couple of other aspects, I shared with you earlier the company's report back to the investors. A lot of investing companies, people who are investing in let's say L&T, websites, stock brokers also track the results and share the results back with the investors. So if you want to invest in L&T or any other share, Reliance or Tata Company or Godrej or Mahindra, whichever company, you can go to websites like the one that I have just taken a screenshot and put it, it's called Money Control, and there are many other websites like this which will show you the P&L statements.

So, you don't always have to go to the annual report of the company, you can get a summary on some of these websites like Money Control. And you'll see that also the year-wise trend is there in this case for this company called Larsen and Toubro. So you can see the sales and right at the bottom you can see the profits. Essentially what I'm trying to say is this is a P&L, a profit and loss or an income statement. I'm encouraging you to get used to reading financial statements.

And you can also find comparison studies if you go to some of these public websites. Again, this is Money Control which is a public website. When the company presents it to its investor it will talk only about itself. But a website or a stock broker or a share, DMAT service provider will compare also. So in this case you can see Larsen, Toubro compared with other companies in the same industry.

GMR airports, IRB Infra, ERCON, et cetera. And these are peer companies to L&T. And you can look at things like ratios and you can see right in the middle a ratio called return on equity. So now what I've tried to do is give a very, very high level, very simple overview of accounting and finance with some very simple case studies, public domain. But if you want to pursue a full-time finance career, you have to develop some of these skills. And if you're an entrepreneur you still need to develop some of these skills, maybe not be an expert but at least have an understanding.

And these are some of the finance skills. You have to be good at numbers. Finance is all about numbers. You have to be good at numbers. You have to have analytical skills. You have to be able to manage data because a big company will have terabytes of data.

You have to understand money. Business is all about money. So cash flow, you have to have accounting skills like the ones I talked about, some financial management skills, business skills. As you go up the ladder you have to have interpersonal skills because when you're an analyst you're just analyzing. But as you go up the ladder and become a CFO, chief financial officer, you have to work with stakeholders.

You have to go to the shareholder meeting. There may be a thousand, ten thousand, a hundred thousand shareholders to talk to them. You have to be able to talk to banks and, private equity and venture capitalists. So, to have good interpersonal skills, you have to manage your employee base. A finance department in a very large company can have thousands of people.

You need to have some understanding of financial software. You need to have management experience where the finance function can be very big. You need to be able to network in the industry and understand industry's trends. Remember, the CFO is a big advisor to the CEO, the chief executive officer. Usually, a CEO, the head of the business, will consult the CFO very closely in his planning stage, in his business planning, financial planning, investment decision, acquisition, mergers, et cetera. And increasingly, because FinTech is coming in a big way, you need to develop some FinTech skills.

Those of you who choose finance as a career, as I said, you can become a CA, cost accountant, MBA in finance, do a commerce course, et cetera. As an entrepreneur, you should still have some course and some skills. Now, again, to end this module, I would encourage you to reflect. Think of a company that you would like to join or are already working for. Now you go and visit, not the company website, but maybe a financial or a stock market website, moneycontrol.com and there are many others who can do a search. You could visit an American or a US or a UK or a Germany or a Japanese website to study Japanese companies or American companies or European companies. Study the price of the share and see the trends. Get a feel for it. Study the financial ratios that are reported in the website. See if there's a linkage between the share price and the financial ratios, especially on a trend basis, last two years, last three years, last four years, last five years.

Look at a peer comparison between the company you're studying and its peers in the same industry and try to look at any analyst report that you can find for that company. And as you reflect, please write it down in your journal.

Thank you. With this, we come to the end of this module. Thank you. Till the next module.